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VOLUME 9 NUMBER 3 • PUBLISHED BY THE CATO INSTITUTE • WINTER 1990

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The CATO JOURNAL is indexed and abstracted in the *Journal of Economic Literature, Current Contents/Social and Behavioral Sciences, Social Sciences Citation Index, America: History and Life, Historical Abstracts,* and the **ABI/INFORM** database. The CATO JOURNAL is available on microfilm from University Microfilms International, Ann Arbor, Michigan 48106.

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Law as a Discovery Procedure

Gregory B. Christainsen

Introduction

The process by which disputes are resolved in courts of law has long been viewed as a type of discovery procedure. It has been argued, for example, that common law judges do not decide cases by imposing their will on litigants. Instead, they merely find ("discover") the rules of conduct that have applied in other, similar cases and situations. In so doing, it is argued that judges use the knowledge embedded in customs and precedents, knowledge that is dispersed among millions of people and tested by centuries of experience.[1]

In recent years another social process that has attained status as a discovery procedure is the process of economic competition in free markets. This view developed from a lecture given by F. A. Hayek at the 1968 meetings of the Philadelphia Society.[2] In that lecture, the future Nobel laureate said:

> I propose to consider competition as a procedure for the discovery of such facts as, without resort to it, would not be known to anyone, or at least would not be utilized.
>
> This may at first appear so obvious and incontestable as hardly to deserve attention. Yet, some interesting consequences that are not so obvious immediately follow [Hayek 1978, pp. 179–80].

Cato Journal, Vol. 9, No. 3 (Winter 1990). Copyright © Cato Institute. All rights reserved.

The author is Professor of Economics at California State University–Hayward. The bulk of the research for this paper was conducted while he was Visiting Scholar at Harvard Law School. The author is grateful to Sanford Ikeda and to participants in seminars at Harvard and American University for helpful comments. He also wishes to thank his mentor in ethics and jurisprudence, Marcus Singer, and Bruce Benson for many useful discussions and leads to reference material. The usual disclaimer applies.

[1]See, for example, Leoni (1972).

[2]"Competition as a Discovery Procedure," Chicago, 29 March 1968. Published in Hayek (1978). For a more recent discussion of competition as a discovery procedure, see Kirzner (1985).

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This paper will attempt to unify the respective notions of a discovery procedure that are present in the study of law and economics. The second section of this paper will briefly review the relevant parts of Hayek's argument and clarify what is meant by an "effective" discovery procedure. The third section will explain why the common law process is not, in fact, a procedure that is systematically effective in discovering legal rules. Government legislative processes are seen to be ineffective for the same reason. The third section will then outline a private legal process that, arguably, offers more promise.

The fourth and fifth sections will discuss some criticisms of a private legal process, emphasizing those made by William Landes and Richard Posner. The sixth section will argue that, even if it were ultimately found to be defective, the mere outlining of such a process yields "some interesting consequences that are not so obvious" for traditional issues in legal philosophy. The issues will include questions in tort and contract law, the proper relationship between law and morality, and whether law and morality are properly seen as essentially utilitarian devices or as manifestations of *rights* to be honored independent of utilitarian considerations.

Competition as a Discovery Procedure: A Recapitulation

Hayek's 1968 lecture grew out of a 1945 paper (Hayek 1945) and a lecture given at the London Economic Club in 1936.[3] Early on, Hayek made the simple point that knowledge in society is not located all in one place (e.g., in the central government) and never can be. In his 1945 article he argued that this is especially so in light of the fact that most knowledge does not exist in the form of a conscious awareness of the rules governing natural and social phenomena—"scientific" knowledge. Rather, most knowledge consists of an informal or tacit awareness of "circumstances of time and place"—knowledge of the likes and dislikes of particular people, trends in the flow of traffic, intricacies of various jobs, conditions in different neighborhoods, and so on. Such knowledge of heterogeneous conditions and preferences cannot be communicated in any practical way to a central planner (who would then issue directives to enterprises). The people who have this knowledge are often not even conscious of the fact that they have it, and a planner who did not have this knowledge in the first place would not even know all the questions to ask to get it. Decentralized markets, on the other hand, make spontaneous and

[3]"Economics and Knowledge," 10 November 1936. Published in Hayek (1937).

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economical use of this informal knowledge as individuals pursue their various interests. Without individuals even being aware of the process, prices spread information about the availability of resources and coordinate people's actions.

In his 1968 lecture Hayek elaborated on this theme by pointing out how the profit incentives of the competitive market process provide a means of mobilizing and transmitting knowledge, which is dispersed throughout society. At the same time, losses provide negative feedback that helps to root out errors and contradictions in people's beliefs. It should be clear from a close reading of the quotation at the beginning of this paper that Hayek's lecture went beyond describing a process whereby people use preexisting knowledge. He was also speaking of a process whereby new knowledge is uncovered. At a later date, Hayek (1979, p. 190) expressed this point by saying that a person "will discover what he knows or can find out only when faced with a problem where this will help."[4]

Thus, people acting within a competitive process can progressively discover what wants are worth satisfying. Economical ways of satisfying these wants, including appropriate organizational forms for enterprises, can be discovered as well.

As Hayek commented at the end of his 1968 lecture, however, an effective competitive process requires a complementary legal environment that defines and enforces rights concerning property and contracts. But Hayek's 1968 lecture did not go far in outlining the features of such a legal environment except to say that appropriate "protection for private initiatives and enterprise can only ever be achieved through the institution of private property and the whole aggregate of libertarian institutions of law" (Hayek 1978, p. 190).

The Legal Foundations for Effective Discovery Procedures

Elsewhere, of course, Hayek has expounded at great length about the importance of an appropriate legal framework. His writings are full of admiration for the common law process as a generally effective mechanism for the discovery of legal rules.[5] He has also been critical of this process in certain respects and has looked to legislation as a corrective device (Hayek 1973, pp. 88–89). But neither Hayek's praise nor his limited criticism of the common law process takes full account of the modern literature on the economics of property rights

[4]Quoted in Kirzner (1987, p. 13).

[5]See especially Hayek (1960, 1973).

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and other research in law and economics. As we shall see, this work makes clear why the common law process sometimes goes awry; it has started to articulate the precise conditions under which the process will, or will not, be effective. It also suggests why government legislative bodies cannot be counted on as a corrective device and points to radically different legal institutions as a possible means of at least shedding light on the principles on which many legal issues might be resolved.

The Concept of an Effective Discovery Procedure

First, the concept of an "effective" discovery procedure must be clarified. It might be asked, for example, how this notion differs from the concept of economic efficiency typically used in neoclassical economics. The two concepts are indeed related, but neoclassical economic efficiency (as conventionally discussed) refers to a hypothetical situation of equilibrium in which all gains from trade (including "trades" with nature such as investments in labor-saving devices) have been exhausted. It implies that the process that presumably brought this state of affairs into existence has done its work and has (momentarily) ceased to operate. The notion of an effective discovery procedure, on the other hand, refers to an ongoing process whereby information about not-yet-exhausted gains from trade is continually and economically uncovered and disseminated to individuals. It refers to the learning that takes place under perpetual disequilibrium rather than a general equilibrium in which all learning has stopped.

Standard neoclassical models can claim to take into account dynamic considerations by discounting the future benefits and costs of various actions through some interest rate. But it is also the case that, because these models focus on end-states (equilibria) rather than an ongoing process, they tend to engender a static outlook. Such an outlook can mislead an individual when forming normative judgments about social processes because, although a particular process might be performing better than any alternative could, a snapshot of the conditions prevailing at any particular moment (e.g., prices not equal to marginal costs, uninternalized external benefits) might lead one to conclude that the process was not working effectively.

Moreover, standard neoclassical models abstract from transactions costs—the costs of seeking out, negotiating, and enforcing agreeable terms of trade among individuals. Incredibly, many evaluations of social institutions still implicitly compare the way in which they allocate resources in the presence of transactions costs with a situation in which transaction costs are assumed not to exist. Not surpris-

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ingly, the institutions in question will then be deemed to be flawed in some way (Demsetz 1969).

In fact, under complementary legal institutions, the process of competition in free markets discovers ways to reduce transactions costs as well as other costs (e.g., production costs). In a world of scarce resources, on the other hand, it is usually not worthwhile to drive costs down to zero, and it is the existence of positive transactions costs that lies behind what standard neoclassical analysis refers to as market failures—the existence of monopoly power, uninternalized externalities, and public goods (Dahlman 1979). So unless there is an alternative process that is *systematically* better at economizing on transactions costs, "market failures" are not worth eliminating.[6]

To summarize, if we say that one social process constitutes a more effective discovery procedure than another, we mean that it constitutes a systematically more economical way of generating and transmitting information about not-yet-exhausted gains from trade (as these are subjectively valued by individuals), including information about those gains that are or are not attainable after considering transactions costs. One might, therefore, say that an effective discovery procedure is Austrian economics' disequilibrium counterpart to a neoclassical concept of an efficient equilibrium in which the presence of information and transactions costs has been fully accounted for.

Property Rights and Effective Discovery Procedures

It cannot be said that a majority of the economics profession, let alone the legal profession, has really grasped the nature and implications of the property rights structure that underlies a systematically effective discovery procedure. It has by now been established that any institution, whether private or public, will systematically fail (in a standard neoclassical sense) unless it is governed by a property rights structure that is complete (i.e., a structure wherein rights are defined, enforced, and transferable). What must be more plainly said is that government institutions, by definition, involve property rights that are not freely transferable. If they were freely transferable, they would be private property. At the same time, it must be pointed out that defining, enforcing, or transferring property rights is sometimes very costly, so that it may not always be worthwhile for these activities to be carried out to the full extent abstractly possible.

So, in a sense, the law and economics literature has painted itself into a corner. That is, institutional failure is seen as avoidable—

[6]Technically speaking, they would be Pareto-irrelevant.

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if appropriate property rights structures can be established. The establishment of appropriate property rights structures is, in turn, seen as a basic function of government. But government itself is governed by a property rights structure that the literature would deem inappropriate, so how can it be expected to carry out its tasks successfully? Modern legislatures in particular have been thoroughly critiqued in the literature on public choice.[7] In their defense, one can only try to argue that alternative institutions are worse.[8]

On a more optimistic note, some writers have viewed the system of common law that has grown up in the Anglo-Saxon world as the product of a procedure that generally promotes economic efficiency. Richard Posner has, of course, been this view's most vigorous proponent (Posner 1986, Part II).

In a review of the now-voluminous literature on the alleged efficiency of the common law, Peter Aranson counted 5,971,968 possible combinations of assumptions about conditions under which the legal process operates (Aranson 1986a). Many, perhaps most, of these combinations are consistent with neoclassical economic efficiency, but many are not.[9] Still others remain to be analyzed.

Insofar as the common law process is defective, Hayek (1973, p. 89) has attributed its shortcomings primarily to the (upper) class interests of judges: "the development of the law has lain in the hands of members of a particular class whose traditional views made them regard as just what could not meet the more general requirements of justice."[10] Hayek provides some other possible explanations for the common law process being defective, but none of them gets to the fundamental issue: the property rights structure governing the process. It is not necessarily undesirable if upper-class individuals provide people with clothes or hotel accommodations. The discovery procedure of the market on some occasions overtly selects such individuals to be suppliers. Should the provision of legal dispute-resolution and rule-making services be different? Perhaps so, but there is no real way to know without an effective discovery procedure. And an effective discovery procedure requires an appropriate property rights structure. Even if upper-class people tended to emerge as judges under such a structure, they would not necessarily act in

[7]See, for example, Kramer (1972); Gibbard (1973); Satterthwaite (1975); McKelvey and Niemi (1978); and Denzau, Riker, and Shepsle (1985).

[8]For additional discussion as to why governments establish property rights structures that are neoclassically inefficient, see North (1981, chap. 3).

[9]For some examples of tort rules that are not efficient, see Rizzo (1979).

[10]See Posner (1986, pp. 233–38) for a discussion of some common law rules that might appear to have been distorted by class bias, but are actually efficient.

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the same way as in a common law process, because the system of incentives would be different. So again, the class interests of judges, or even their personal ideologies, are not the main issue. The property rights structure is. Insofar as common law judges are decision-makers of enterprises—government courts—for which rights are not transferable, and sometimes not even defined, they are in the position of central economic planners.[11] They cannot know all the circumstances of time and place that would be relevant to efficient decisions, and there is no discovery procedure to duplicate that which prevails in free markets.[12]

An Alternative

We now proceed to outline a legal system that is governed by a property rights structure which would appear to be more complete than that of the common law (or of government legislatures).[13] It can be argued, however, that in some respects the property rights structure governing this alternative is still not complete. Two points should be made about this qualification at the outset.

First, as mentioned earlier, because it is costly to define, enforce, and transfer property rights, it may not always be worthwhile to articulate a complete set of rights; the resources that would be employed to do this have alternative uses. It is, therefore, likely that at any point there would still exist some "commons" areas.

Second, to the extent that incomplete property rights manifest themselves in the form of externalities and to the extent that, inclusive of transactions costs considerations, there are net benefits to be had by internalizing them, then there will be opportunities for the evolution of institutions to do so—provided that there are no legal barriers to the operation of market forces.[14] This simple point tends

[11]For related discussions of this point, but with less of an emphasis on property rights, see Epstein (1980), Rizzo (1980a), O'Driscoll (1980), Rizzo (1980b), Epstein (1982), Rizzo (1985), and Aranson (1986b).

[12]It should be noted that insofar as the articulation of legal rights affects people's wealth, the pattern of demands for goods and services, and relative prices, the neoclassical concept of efficiency is, in this context, somewhat ambiguous. This is not to say, however, that the concept is empty or "a mirage." But see Rizzo (1980b).

[13]Though differing in detail, this model was inspired by the model put forth in Rothbard (1970, chap. 1).

[14]Of course, genuine "prisoner dilemma" situations do exist wherein, from an individual standpoint, the incentives to cooperate with others to internalize benefits are ambiguous. The question then is simply this: Given that such dilemmas exist in a world of transactions costs, what institutions work best? Are they monopolies over the use of coercion and that operate under incomplete property rights? Perhaps. But for a discussion of how cooperative behavior may turn out to be a dominant strategy in prisoner-dilemma situations under *noncoercive* institutions, see Axelrod (1984).

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to be lost when markets are analyzed in terms of (static) equilibrium states instead of being viewed as part of an ongoing (dynamic) process of discovery.

To say that the property rights structure governing the resolution of legal disputes is complete, or nearly complete, would be, of course, to say that the legal system had been privatized. It is not difficult to see how a private system would operate in cases where the parties to a dispute agree to be bound by the decision of a particular arbitrator. But in cases where the parties do not have such an agreement or, more dramatically, where certain people (e.g., criminals) brazenly refuse to be bound by any judge or any law whatsoever, it is less clear how a private legal system would function. And if everyone's assets were subject to the whims of gangs or private armies, the property rights structure would, of course, be very far from complete.

The model for such a system is as follows: If X accuses Y of wrongful behavior, X may bring suit against Y in any private court willing to hear the case. If Y agrees to submit to the decision of the court, the ruling of that court settles the matter. But Y might refuse to submit to the decision of that court. He might instead turn to a court of his own choosing or to a private protection agency to defend his interests. At this point, there is the potential for violence between X and Y, or between their respective agents, just as there would be if Y refused to submit to the decision of a public court in today's world. Put simply, an individual would resort to violence if the expected benefits exceeded the expected costs. So if the stakes in the dispute were relatively high, and if the damages (to one's person, property, reputation, etc.) that one expected to result from a violent confrontation were relatively low, there might well be violence.[15]

The above conditions would undoubtedly exist on many occasions under a private legal system. They often exist in today's world. On the other hand, even if the technology of violence (fists, clubs, guns, bombs, etc.) in the possession of the parties were rather unequal, negotiation or submission to arbitration might be a preferred strategy. Even if one party could expect to "win" a violent confrontation, the costs of doing so might leave the net benefits to that party lower than they would have been under a peaceful strategy.[16]

[15]One argument in favor of having a powerful state is thus that the expected costs of fighting the state are so high that private parties will be deterred by and large from using violence. The question is then whether the state itself can be effectively constrained in using coercive power.

[16]A related issue is how the efficient scale of operation for private protection agencies would compare to that for criminal groups. Gordon Tullock, for example, fears that criminal groups would operate on such a scale that they would dominate society, but

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One can, of course, find historical examples of both violence and negotiation or arbitration. One can also find various strategies based on bluffs. A priori, the quantity of violence in the model is indeterminate. What is relevant are the empirical studies of how the various facets of a private legal system operate in comparison to those of other legal processes (the common law, legislation, dictatorship, etc.). It is worth noting, for example, that in his study of the spontaneous emergence of private property rights in California's gold fields, John Umbeck (1981) found that there was actually relatively little violence in those fields during the gold rush of the late 1840s.[17] To cite another example, David Friedman (1979) has estimated that, at its worst, the average number of people killed or executed per year under medieval Iceland's private legal system was, on a per capita basis, about the same as the rate of murder and nonnegligent manslaughter in the United States in 1976.

It is asserted here that individuals acting under a private legal system would generally conclude that submitting to some peaceful means of resolving disputes is preferable to the use of violence. In the model discussed above, the respective agents of X and Y might negotiate a settlement or agree to submit to a private court's decision. In any event—including the possibility that Y would be forcibly brought to trial—if Y were ultimately found guilty of wrongdoing, he could try to appeal the case somewhere. If Y could not overturn the decision, however, he might be subject to some form of punishment, such as providing restitution to X.[18]

As various kinds of cases were resolved, a system of law would evolve. Over time, the resolution of new and different cases would produce an ever-more sophisticated set of rules to guide individual conduct. Just as no one can forecast the precise set of prices that will govern private market transactions during a particular period, no one can be sure of the precise rules that would govern the resolution of disputes in a private legal system during a particular period. Rules would emerge through a process of discovery. Ex post, moral and legal philosophers might be competent to discuss the general characteristics of the rules of conduct that emerged, just as some economists

Anderson and Hill's (1979) study of the American West found little to support that view.

[17]Umbeck's title was meant only to point out that even a benign set of rights is often enforced by the threat of violence.

[18]There would naturally be cases over which more than one court granted jurisdiction. The courts involved might indeed follow conflicting rules as to how the case should be resolved. An entire body of law called "the conflict of laws" has arisen to deal with such situations, however, and this law evolved spontaneously. See Weintraub (1980).

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are competent to discuss the general nature of factors that determine prices in free markets. No economist, however, is competent to deduce the whole set of market prices a priori, and no moral or legal philosopher would be competent to deduce the whole set of legal rules in advance. To try to do so would be to fall victim to an uncritical rationalist hubris. Following Hayek, spontaneous social processes, including spontaneous legal processes, use more information than any single person or group can ever possess.

Points of Controversy

Six major points of controversy will now be discussed with respect to a private legal system: (1) the incentives for private courts to provide impartial justice, (2) the incentives to articulate legal precedents, (3) the incentives for standardizing legal rules across jurisdictions, (4) the problems posed by instances of large numbers of small claims, (5) the private protection for legal rights that would emerge, and (6) the desirability of the social conventions that would underlie a private system of law. All of these points of controversy cast doubt on whether a private legal system would be governed by an effective legal discovery procedure.

With respect to the first point of controversy, Landes and Posner (1979, p. 254) have argued that competition among courts might not suffice to resolve disputes in an optimal manner insofar as it is the plaintiff who determines the choice among courts having concurrent jurisdiction over his claim. Thus, they argue, both the substantive and procedural rules that emerged would systematically favor plaintiffs at the expense of defendants, neoclassical efficiency, and, more intuitively, basic notions of fairness. In a similar fashion, it can be argued that the decisions reached by private judges would systematically favor wealthy litigants, who could afford to pay higher court fees than poorer clients.

With respect to the second point of controversy, Landes and Posner have noted that there is a difference between resolving disputes and articulating legal rules (i.e., precedents) to guide future decisionmaking. Even if private judges resolved disputes efficiently, it is argued that since the interests of future decisionmakers are not fully represented in present cases, a private legal system would underproduce precedents (Landes and Posner 1979, pp. 238–39). In other words, the articulation of precedents is viewed as having benefits that a free market would fail to internalize.

The third point of controversy—the incentives for standardizing legal rules across jurisdictions—is Hayek's main concern about a private system of justice.

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> I believe there is one convincing argument why you can't leave even the law to voluntary evolution: the great society depends on your being able to expect that any stranger you encounter in a given territory will obey the same system of rules of law. Otherwise you would be confined to people whom you know. . . . So in a sense you have, at least for a given territory, a uniform law and that can only exist if it's enforced by government.[19]

According to this argument, a common system of law, like a common language or a common money, reduces transactions costs among strangers. The alleged market failure is that, although nearly everyone would benefit from a common legal system, private courts resolving disputes on a case-by-case basis would have incentives to cater to the more immediate, heterogeneous interests of their clients instead of to the public good of legal uniformity; privately produced law would be haphazard and would render behavior unpredictable.

With respect to the fourth point of controversy—instances of large numbers of small claims—the argument is that, unless the claims could be feasibly aggregated in the form of class-action suits, the litigation costs could be so enormous that even highly imperfect government legislation to govern the activity in question would be preferable to a system of courts.[20] Even if class-action suits were used, there could still be tremendous problems in allocating damage awards among all parties to the suit. In the case of air pollution caused by automobiles, for example, would the millions of people who are injured in some way have to try to divide up damage awards that they would collect from millions of drivers?

The fifth area of controversy—the operation of private protection agencies—revolves around two possible market failures. First, are there not external benefits that derive from an agency's patrolling an area? That is, if someone pays a security agency to deter criminal activity in a certain area, will that not benefit others who might not have paid the agency? And if an inability to collect from all beneficiaries encourages free-riding behavior, wouldn't that discourage an optimal amount of protection from being provided? Second is the argument that protection is a natural monopoly. Robert Nozick (1974, Part I) and also James Buchanan (1977, p. 52) have put forth this view. According to Buchanan:

[19]*Nobel Prize-Winning Economist: Friedrich A. von Hayek*, interview conducted by the Oral History Program, University of California–Los Angeles (1983, p. 348). See also Landes and Posner (1979, p. 239).

[20]Posner has pointed out that it is unclear whether indemnity offers any improvement in efficiency here. It may reduce legal errors but increase litigation costs. See Posner (1986, pp. 537–40).

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> Conflicts may occur, and one agency will win. Persons who have previously been clients of losing agencies will desert and commence purchasing their protection from winning agencies. In this manner, a single protective agency or association will eventually come to dominate the market for policing services over a territory.

As previously discussed in this paper, there is thus a fear that conflicts would be resolved by violence instead of by developing legal rules. The argument now is not only that violence would be widespread, but that there would be large economies of scale in the use of force, and the agency that would be able to reap these economies would be in a position where "might makes right." In fact, if and when a single agency gained a dominant position with respect to the use of coercion, it would constitute an emerging state.[21]

The sixth and last point of controversy involves the formation of social conventions such as values and norms that underlie a system of law. There is a fear, which goes back at least as far as Aristotle, that if values and norms are left to spontaneous evolution, society is likely to become increasingly decadent; if left to their own devices, law and social order generally may break down over time. Once more, it is argued, a state is a necessary evil in the struggle to cope with some of the defects of extensive liberty.

Counterpoints

Private Courts to Dispense Impartial Justice

Let us look at each point of controversy in order. First is the issue as to whether private courts would dispense impartial justice. Landes and Posner (1979, p. 255) comment that during the centuries when English plaintiffs often had a choice among competing courts, there was "none (of which we are aware) of the blatant plaintiff favoritism that our economic analysis predicts would emerge in such a competitive setting." They also provide the proper explanation as to why history did not conform to their theory: Under competing courts, the defendant may be able to opt out of the forum preferred by the plaintiff (p. 254). There must then be a negotiated agreement or some other method of deciding on the court to which their dispute is submitted. Landes and Posner reject this explanation as a general answer to the problem of dispensing impartial justice in a private legal system, because they worry about cases wherein a defendant who fears the outcome of unbiased adjudication refuses to have his

[21]A state can be defined as an agency with a concentration of the privileged use of force. In a literal sense, the state does not have a monopoly.

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dispute heard in an impartial setting. "This problem can be overcome only if the parties to a contract agree in advance to the submission of any dispute arising from the contract to a particular tribunal" (p. 254).

What Landes and Posner do not discuss are the range of possibilities for pressuring or even coercing recalcitrant parties who have not previously agreed to a particular tribunal. The threat of coercion is the ultimate weapon that a government has in the event that a party refuses to submit to a court's jurisdiction, and Landes and Posner do not object to government's having a (virtual) monopoly over coercion's legitimate uses. In England beginning in the 11th century, however, the Roman Catholic church used its much-feared power of excommunication in competition with the coercive power of secular authorities. Secular authorities could act on behalf of their courts with armed might, but those who sought refuge in the church's ecclesiastical courts could, in many cases, call on what the devout considered to be an even greater power.

To be sure, secular officials often used coercion arbitrarily, and church officials can be criticized for the manner in which the excommunicative power was sometimes used, but—after what was admittedly a long struggle—the most striking outcome of such confrontations was the emergence (discovery) of relatively uniform rules of law to resolve differences among competing court systems. These rules were independent of the will of any single (monopoly) authority. The issues governed by them included not only a variety of substantive disputes among individuals, but procedural disputes between church and king concerning court jurisdictions and recalcitrant parties (Berman 1983, chap. 7).[22]

The point here is thus that recalcitrants can indeed be pressured into appearances before (presumably) impartial adjudicators, even in the absence of contracts, under the protections of a rule of law that is the result of a competitive process. In addition to providing an answer to Landes and Posner's concerns about impartial justice for defendants, such a process provided the means by which individuals from historically oppressed classes started to gain a greater degree of autonomy during the Middle Ages.[23]

[22]Competing court systems also developed *within* the secular sphere. It should be noted that many decisions were enforced by a threat of ostracism rather than coercion.

[23]"A serf might run to the town court for protection against his master. A vassal might run to the king's court for protection against his lord. A cleric might run to the ecclesiastical court for protection against the king" (Berman 1983, p. 10). See also pp. 292–94 and pp. 542–43. Rather than seeing the Middle Ages as a stagnant period of serfdom, Berman argues that it was a revolutionary period during which the Western legal tradition started to take form.

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Private Articulation of Legal Precedents

The next issue—the incentives of private arbitrators to articulate precedents—again finds Landes and Posner providing at least part of the reply to their own concern. At one point, Landes and Posner (1979, pp. 257–58) argue that commercial arbitrators do not set precedents but just apply those established by government courts. They recognize, however, that the Law Merchant system of the Middle Ages, which involved the use of private courts and law for the adjudication of commercial disputes, developed a large, some would say phenomenal, body of precedents. This body of precedents was eventually absorbed into government law as royal courts competed for clients against merchant courts. In England in 1606, however, Lord (Edward) Coke asserted that the rulings of merchant courts could be countermanded by royal tribunals, and the Law Merchant declined vis-à-vis public courts. Thereafter, the development of commercial law precedents slowed, and merchants gradually started going back to private arbitration (Trakman 1983, pp. 25–26). Landes and Posner (1979, p. 258) note that the renewed competition apparently stimulated important procedural reforms in England in the 19th century, and in the 20th century private arbitration has again become a major factor in settling commercial disputes. In many respects, then, the causation with regard to who sets and who just applies precedents has run from private to public sector.

In a private legal system, the articulation of clear and unbiased precedents would be a matter of self-interest for courts insofar as it is a way of establishing brand-name capital. Landes and Posner are aware of this, but argue that private courts would not have an interest in precedents if cheaper forms of advertising existed (Landes and Posner 1979, p. 239).

From a more dynamic perspective, however, one can see why the incentives to articulate precedents would be likely to dominate. First, one can envision a market in legal decisions in which enterprising courts would sell the written opinions of their judges to law firms or to the various retrieval services on which lawyers rely (Barnett 1986, p. 38). Beyond this, one would expect the formation of insurance organizations to help individuals and firms pool risks with respect to liability and litigation costs. Individuals or firms could pay a flat fee to such organizations, as is the case with today's Health Maintenance Organizations (HMOs) in the field of medical care. To the extent that these organizations had clients with conflicting interests—with some clients more likely to be plaintiffs in certain classes of cases, and other clients more likely to be defendants—

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the organizations would have an interest in having courts articulate unbiased precedents, so as to minimize the number of future disputes occurring and, in turn, their costs. These organizations would also have an interest in reducing litigation costs by encouraging law-abiding behavior on the part of their clients. The organizations would thus be a modern-day version of the surety associations that developed under primitive legal systems such as that of the Yurok Indians (Goldschmidt 1951, p. 512) and that also appeared in both medieval Europe and Iceland.[24]

In a private legal system, one would expect courts to compete with each other to establish contractual arrangements with such organizations. The organizations would agree in advance to bring their disputes to those tribunals that had reputations for setting clear precedents—precedents being a legal version of preventive medicine. Even if a legal insurance organization had clients whose future concerns were totally biased (e.g., they were all sellers of a particular product known to be hazardous), the court with whom that organization does business might at the same time have contractual arrangements with other insurance organizations having diametrically opposed future concerns (e.g., they might represent consumer groups). Of course, if a court were known to issue biased rulings, we would be back at the question of whether private courts would dispense impartial justice. In any event, it seems clear that there would be ample incentives to put forth precedents.

By contrast, it is not clear that the incentives facing public courts are as strong. To some extent, judges may wish to articulate precedents as a way of acquiring prestige, but insofar as litigants' fees in public courts are below market-clearing rates, there is an excess demand for court services—the so-called caseload crisis. Tribunals may then—either deliberately or because of force of circumstance—ration scarce court time by avoiding or delaying precedent-setting cases.

Standardization of Legal Rules

As is true for the issue of precedents, the question of legal uniformity provides a good case study for what Harold Demsetz (1969, p. 1) has called the "comparative institutions" approach to questions of public policy. To say that private institutions would not provide the degree of uniformity that would be neoclassically optimal under zero

[24]On the use of sureties in medieval Ireland, see Peden (1977). On the Anglo-Saxon tradition, see Stephen (n.d., Vol. 1, pp. 65–67). See also Blair (1956, pp. 232–35). On the use of sureties in medieval Iceland, see Friedman (1979). It should be noted that in medieval times membership in a surety was often compulsory.

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transactions costs is not to say that government institutions—which operate under positive transactions costs—produce a better result. One must compare the reality of a set of institutions with the reality of the other, not the reality of a set with the result one idealizes the other set is capable of producing under certain hypotheticals.

Commercial law again stands out. When one examines its history, one sees a pattern of behavior on the part of legislative bodies with regard to standardizing legal rules; this pattern is mixed at best. The development and adoption of the Uniform Commercial Code may seem to be a good example of an instance where legislative activity eventually helped to rationalize a melange of laws that had previously governed commerce. On the other hand, the existence of a problem to be solved was a result of the fact that government institutions did not produce legal uniformity. There were, and are, multiple state jurisdictions with often-conflicting rules. Moreover, the Uniform Commercial Code was based primarily on the principles of the Law Merchant; "the positive law of the realm was forced to conform to the mandates of the merchants, not vice versa" (Trakman 1983, p. 34).

On an international scale, the problems of multiple governmental jurisdictions have been even more pronounced, often leading to wars, and private arbitration has reemerged as a potent force in the 20th century, in part to promote greater legal uniformity than occurs under public jurisdictions separated by arbitrary political boundaries.[25] The International Chamber of Commerce Court of Arbitration, established in 1923, is one of more than 120 private organizations that help to adjudicate international trade disputes (Lazarus et al. 1965, p. 29). Many of these organizations focus on disputes regarding particular products. Others specialize on a territorial basis. The jurisdictions overlap and are free to evolve spontaneously. The establishment of various public jurisdictions in the form of nation-states and provinces has not been subject to such a discovery procedure.

A similar contrast between the public and private sectors was evident centuries ago. The universal character of the Law Merchant has been stressed by almost every scholar who has written about it.[26] Local government laws, however, often discriminated against

[25]One might ask why competing private agencies such as those under discussion would not be just as likely as nation-states to generate armed conflict on a mass scale. The brief answer is that the leaders of nation-states can more easily compel their subjects to subsidize the costs of their excesses.

[26]"Each country, it may almost be said each town, had its own variety of Law Merchant, yet all were but varieties of the same species. Everywhere the leading principles and the most important rules were the same, or tended to become the same" (Mitchell 1904, p. 9).

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"merchant strangers." They still do, as evidenced by modern protectionism.

Of course, law must to some extent show local variations to reflect differences in conditions and customs, and privately produced law has done this, a point stressed by Anderson and Hill (1979) as well as by Mitchell (1904). The common law has also at times shown an admirable degree of variation in its rules regarding, for example, water rights and liability for stray cattle (Posner 1987, p. 6). On the other hand, public authorities have often imposed uniformity where it is not called for, such as the U.S. government's setting of motor-vehicle speed limits that do not distinguish between conditions in New Jersey and Nevada.

But the more important point is that the degree of the law's uniformity that does, in fact, emerge under more pluralistic legal institutions (e.g., the Law Merchant) contributes to the view that there exists a rule of law that is independent of the will of state rulers. Indeed, the existence of pluralistic legal institutions makes the rule of law necessary as a means of economizing on the costs of resolving disputes among courts with overlapping jurisdictions. And the rule of law is the protector of liberty.

Problems of Large Numbers of Small Claims

Cases involving large numbers of potential litigants pose severe problems for any legal system. To be sure, litigation is often desirable as a means of resolving disputes and making people internalize the effects their actions may have on others. Litigation involves costs, however, and at some point these costs may be overwhelming.

The automobile has generated perhaps the most striking examples. Consider accidents and auto insurance. The litigation costs involved in determining who is to be held responsible for accidents have in some states become so enormous that they have accounted for 50 percent or more of people's auto insurance premiums. Assume for the sake of argument that moving to a system of no-fault insurance would be the most economical solution. Would there exist in a private legal system incentives for moving to such a system? Would private courts not welcome litigation as a boon to their profits?

Businesses, including private courts, certainly welcome a strong demand for their products, but one must be careful about exactly what it is that people want. Depending on the circumstances, people demand litigation-avoidance rather than litigation. More specifically, one would expect insurance companies in a private legal system to associate only with those courts that economized on the need for litigation. This association would be the private sector counterpart

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to companies' lobbying of politicians for no-fault insurance under current institutions. In a private legal system an enterprising court could announce that, effective on such-and-such a date, it would offer new contractual terms for insurance companies so that, in return for a flat fee that was based on a company's past involvement in legal disputes, the court would hear any cases the company wished to bring before it during the next 12 months—under the proviso that the court would refuse to assign fault in accident cases involving motor vehicles. Assuming insurance companies would prefer a no-fault system, such a court could charge lower fees and gain a competitive edge.

Now suppose Insurance Company X associates with Court A, which has a no-fault stance, but Insurance Company Y is associated with Court B, which has continued to assign fault in car-accident cases. What would happen if a driver with a Company X insurance policy had an accident involving a driver with a Company Y policy? One would then simply have a special case of the more general issue of conflict-of-laws across jurisdictions. As noted previously,[27] the principles involved in resolving such conflicts developed spontaneously, with nonviolence proving to be economical. In the long run, one would, of course, expect courts like Court B to shift to a no-fault stance in car-accident cases if no-fault were found to be an advantageous approach. Perhaps no-fault would prove to be appropriate for some classes of accidents, but not for others. There is no way to know for sure without an effective discovery procedure.

A second crucial issue generated by the automobile concerns air pollution. Again, if cases were brought before courts on an individual basis, huge numbers of litigants could potentially be involved—the millions of automobile drivers, the companies that make automobiles and their fuel, and the untold numbers of victims of pollution. From the standpoint of an individual pollution victim, the damages suffered might be significant, but the victim might be uncertain about precisely who caused them, and the expected costs of investigating and litigating the matter might be greater than the damages.

If there were a large number of people who might be eligible for damages, however, a class action suit would be an obvious possibility because there might be economies of scale in litigation. Against this possibility is the fact that even if such a suit could be filed, it might be very costly to determine the total damages suffered and to apportion them among the parties to the class action. There would be further difficulties in defining what the appropriate class would be

[27]Supra note 18.

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and in deciding if and under what conditions nonparticipants in class actions would be ineligible to file additional suites.[28] In *Roger J. Diamond v. General Motors*, a California Superior Court judge ruled that an attempt to sue General Motors and other parties in a class action suit on behalf of all the property owners in Los Angeles was not the proper way to deal with the problem of smog. The appeals court affirmed the decision, noting both the difficulties of individualizing damage claims and the traditional role of government legislation in addressing concerns about public nuisances.[29]

It might well be that at some point, it is not worthwhile to try to individualize damages. Public regulation does not do so at all. In a private legal system, on the other hand, legal entrepreneurs would be free to try to organize class actions in any way they wished. A class-action lawyer might propose, for example, that people with certain documentable respiratory problems be entitled to a certain percentage of the total damage award, but that no serious attempt would be made to establish that Person J's problem merited, say, 6.4 percent more in compensation than Person K's. The fineness of the damage categories would itself be an object of discovery.

The number of defendants involved and the burden of proof would also have to be resolved. With regard to the former, it is often not economical to pinpoint all the people and organizations who contributed to one's damages, nor to try to determine the proportion of the damages attributable to each culpable party. In the case of *Roger J. Diamond v. General Motors*, the plaintiff tried to identify 293 corporations and municipalities as appropriate defendants and was unable, of course, to specify exactly how much each party had contributed to smog in Los Angeles, let alone the connection between smog and damages to individual people and properties. To cope with such situations, the law has developed the doctrine of joint and several liability, whereby one, or just a few of the parties, can be sued for all the damages, with the selected parties then having a right in some circumstances to collect compensation from culpable parties who were not originally sued (Posner 1986, pp. 171–74).[30]

[28]For further discussion of such issues, see Kornhauser (1983).

[29]20 C.A. 3d 374 (1971). One might argue that holding auto manufacturers instead of drivers responsible for pollution is like holding gun manufacturers and not gun users responsible for murders, but as Ronald Coase (1960) has pointed out, the relevant issue from an economic standpoint is what liability assignment best economizes on transactions costs.

[30]It should be made clear that the doctrine was originally developed in non–class action settings.

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As regards the burden of proof, the central issue in many environmental cases is the difficulty that victims have in establishing that particular, usually industrial, activities and not something else were indeed the cause of their injuries. Thus, for an individual to show convincingly that the release of chlorofluorocarbons into the atmosphere was the cause of his skin cancer might be prohibitively costly. To cope with such cases, Japanese courts have ruled that in certain, very limited circumstances the plaintiff need show only a strong statistical correlation between his type of injury and the defendant's activity, and the burden of proof is then on the defendant to show that he probably did not cause the plaintiff's injuries (Tietenberg 1988, pp. 448–49). There is, of course, great uncertainty about the seriousness and character of many of these environmental matters (uncertainty that would exist under any legal system). But putting what is called a sequential burden of proof on the defendant, as has now been done in Japan, may be efficient if people are generally averse to environmental risks, and if defendants can acquire information for resolving such disputes at lower cost than plaintiffs.

So imagine a class action in the Los Angeles area under a private legal system in which a law firm organizes a "petition drive" among various categories of potential claimants who sue, say 10 automakers—perhaps only those 10 firms—for all the damages attributable to abnormal concentrations of carbon monoxide, ozone, and nitrogen dioxide in the air. The suit would be based on statistical correlations between unusually high rates of incidence of certain disorders and the presence of these pollutants. Imagine the incentives that automobile manufacturers would have to spontaneously modify the design of their cars if they knew such suits were possible. (In a private legal system, they would have perhaps designed cars differently long ago, when the situation was not so unwieldy.) Is it really obvious that private courts would thereby constitute a less-effective way of dealing with automobile pollution than the reality of current institutions? Similar questions can be posed with respect to the depletion of ozone in the atmosphere and several other environmental concerns.[31]

It must be emphasized that it is precisely because of the difficulty of the legal issues discussed above that an innovative, spontaneous process of discovery is so urgent. If people protest that some firms would be bankrupted by the damages they would have to pay in

[31]Pollution from stationary sources such as factories would presumably pose a simpler problem than that from motor vehicles. Class action suits might again be feasible, but it is also conveivable that courts would rule that initial polluters had homesteaded (limited) property rights in emissions, with the rights then being transferable from one stationary source to another.

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some of these environmental suits, those damages are evidence of the moral "bankruptcy" of current institutions, which have permitted injurious behavior to go on to such an extent. The problems might not be so difficult now if different institutions had been around from the beginning.

Private Protection of Legal Rights

The fifth point of controversy that must be addressed concerns the operation of private protection agencies. Would they involve substantial uninternalized benefits? Would they constitute a natural monopoly that would become a state or dominate society?

Private security agencies have multiplied like rabbits as people have perceived the public police to be inadequate, and one can see the means they have used to internalize the effects of their actions. The argument for the existence of externalities has again been that the deterrent effects of patrols and other enforcement activities on would-be criminals confer spillover benefits on neighbors who did not pay for the security provided. In the case of individual homeowners, however, the market response has been to put signs on the premises informing those passing by that the property is under the purview of such-and-such an agency. The implicit message is that the homes without such signs are *not* protected by that agency.

In a similar vein, the American Automobile Association (AAA) gives its members decals that they can put on their cars to inform people that, if a member's car is stolen, AAA will pay a reward for information leading to its recovery (Friedman 1979, p. 403). Cars without these decals do not have such protection. The point is that people *can* be excluded from security if they do not pay for it; spillover benefits need not exist.

On a larger scale, the market process has evolved as it has in many other instances of potential spillovers: by promoting innovative contracts and institutions to internalize the would-be externalities. Associations of condominium owners often purchase security for an entire area. Storekeepers in malls collectively purchase private protection. Individuals can choose to live in apartment buildings that offer guards or other forms of security. If the public police and the associated taxes were eliminated, one would expect to see ever-more diverse types of protection paid for by homeowners' associations and merchant groups. Most real-estate contracts would probably have the purchase of security be a condition for buying property. To the extent that entities such as streets and parks were privatized, private security could also be provided in what are now "commons" areas.

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As far as the natural monopoly[32] issue is concerned, it should first be noted how many thousands of security agencies are presently across the United States. (The same applies to arbitration services.) A quick look at the Yellow Pages of any major city's telephone directory reveals dozens of firms offering protection of one sort or another. To say, as Buchanan does, "conflicts may occur, and one agency will win," is to assume that agencies continually fight each other until only a single one is left instead of settling disputes in a more peaceful, lower-cost fashion that enables many firms to survive and prosper.

Several examples of stateless societies serviced by private protection efforts have existed in history. Some of these societies lasted far longer than countries that tried to forestall a general outbreak of lawlessness by subjugating a state to a constitution. If those stateless societies did eventually perish or themselves produce states, however, one must explain why.

After five centuries of relative stability, Celtic Ireland and its private legal system were conquered by the British after an additional four centuries of struggle. Britain itself developed a centralized government out of tribal groups as a response to attacks from the Vikings, especially the Danes (Blair 1956, pp. 201–3). The private legal system of medieval Iceland apparently became increasingly centralized and finally broke down in the face of threats from Denmark and Norway.[33] In an oft-cited study of the development of nation-states, Franz Oppenheimer (1926) thus emphasized how states have arisen because of external factors (e.g., threats from outside enemies). It may be that a free market can support a multiplicity of private protection agencies for tremendously long periods when a whole area is not threatened by an outside force (e.g., a state). If the area *is* so threatened, however, market forces may generate a concentration of protection efforts in the endangered area as a response. The concentration of protective forces at some point itself becomes a state.

One must be careful, however, about claiming that stateless societies generate states only as a defensive measure against other states,

[32]One must distinguish "natural monopoly" in the technical sense of "large economies of scale" from "natural monopoly" in the sense of "it has usually ended up as a monopoly." For example, in most developed countries, post offices are virtual monopolies. They thus seem to be "natural" monopolies in the second sense noted above, although there are grave doubts about whether they are natural monopolies in the first sense noted above. We are speaking in the text of the possibility that protection agencies are a natural monopoly in the first sense.

[33]The author claims no expertise on this matter. I owe the statement in the text to an Icelandic political scientist, Hannes Gissurarson. He grants that it is a matter requiring further research. David Friedman (1979, p. 407n) speculates that an increasingly concentrated distribution of wealth may also have played a role in Iceland.

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for this would fail to account for the emergence of the very first state. It may thus be that there *are* occasions when the provision of protective services is a natural monopoly—perhaps when a climate of mistrust develops between sizable groups of people from distinct territories.[34] And if defense (or offense) is to be provided on a large scale, familiar public-good issues arise, perhaps leading to demands that the effort be supported by taxation, conscription, or the creation of fiat money. Needless to say, a purely private legal system would not survive in such conditions.

Social Conventions in a Private System of Law

The final area of controversy is the values (i.e., the social norms or "moral code") that would underlie a nongovernmental system of law. Hirshleifer (1982, p. 37) has argued that just because a group of people converges on a particular set of values does not mean that it has converged on the *best* set of values. On the other hand, Ellickson (1987, pp. 98–99) has argued that, if group members have repeated contact with one another, a free environment will lead to the emergence and general observance of values that are neoclassically efficient.[35]

The efficacy of a group's values is very important for two reasons. First, law grows out of some sense of morality. If the sense of morality that dominates a society is warped in some way, the law is likely to become warped as well. Second, it must be remarked how infrequently most people use the formal apparatus of law. Surveys, for example, reveal that most people know very little about the legal rules that allegedly constrain their behavior (Ellickson 1987, p. 88), and almost two-thirds of the adults in the United States have used an attorney only once in their life or not at all (Ellickson 1987, pp. 89–90). The law is, of course, important, but less-formal norms would appear to be the biggest influence on how people interact with one another.

Much use has now been made of evolutionary theory in an attempt to explain how norms emerge and survive (or perish). Hayek (1984, pp. 318–30; 1988, chap. 1), for example, has drawn analogies between cultural and biological evolution and has spoken of a "group selection" process whereby those species or groups that have advanta-

[34]Posner's study of Homeric society lends support to Oppenheimer's view, but he does not rule out the possibility of states having emerged because of a concentration of wealth or because of demand for large-scale public projects. See Posner (1981, pp. 143–45, 163–65).

[35]Ellickson's argument is based on the principles articulated in Axelrod (1984) [private communication]. See also Smith ([1759] 1976, Part VI, Section II).

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geous traits or norms are likely to prevail, while species or groups with dysfunctional traits or norms are likely to suffer a decline. One complaint about such analyses is that it has been argued in the biological literature that, strictly speaking, evolutionary processes select individuals or genes, not groups (Wilson 1975, pp. 106–29).[36] Thus, a norm of honesty may be generally beneficial to a group, but dishonest individuals within that group may be able to profit at the expense of honest individuals. So dishonest individuals may prevail (Ellickson 1987, p. 95).[37]

In other words, a free-rider (public-good) problem may plague the enforcement of a desirable norm. Most individuals within the group would benefit if everyone else obeyed the norm, but each person considered separately might often benefit by violating it.[38] Recall that Ellickson qualifies his claim about norms being efficient by saying that there must be repeated contact among group members. The rationale for his qualification is that if group members see each other regularly, they are more likely to develop informal sanctions against what is perceived as asocial conduct. This setting of norms is especially so in groups that are relatively small, where it does not cost individuals much to monitor one another. As an example, a rude person can be singled out and excluded from social activities; rudeness can thereby be lessened. If people don't see each other regularly, however, asocial behavior may go unpunished. In the large cities of a mobile society, for example, some people may be offended if Person X drives too aggressively, but Person X is unlikely to encounter those exact people again so why care if they dislike him or her?

Ideally, there would be some external, omniscient force that would sanction wrongdoers like Person X, but government is certainly not it. General civility cannot be imposed by force. God and the fear of the Last Judgment have been suggested as an alternative means of motivating individuals, and Hayek (an agnostic) has, in fact, put great stress on the role that religion has sometimes played in supporting

[36]One can take comfort from the fact that many other animal species observe property rights—crayfish, certain butterflies, etc.—but the relevance of these biological data for forming a positive theory of social evolution among humans is controversial, to say the least.

[37]Whatever the merits of his theory of cultural evolution, Hayek (1988, p. 25) maintains that it does not depend on the existence of group selection in the biological world.

[38]A free-rider problem can likewise inhibit a change in norms; people might be predisposed to change, but there may be situations in which each individual will refrain from changing until others do the same. Thus no one changes (Vanberg 1986, p. 93).

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Western values (Hayek 1988, chap. 9). At other times, of course, religion has played an opposite role.

Insofar as our analysis has maintained that respect for private property and related values is of paramount importance to the operation of an effective discovery procedure, processes of "group selection"—if we may use that term—do appear to work in their favor. Group selection accounts for the perennial net migrations of people from countries where there is relatively little respect for private property to areas where there is relatively more, and this movement has certainly helped the institution of private property to survive (while at the same time helping to delegitimize societies that are hostile to it). The prospects of greater economic success and greater liberty seem to be the main factors driving these net migration flows.

There is, on the other hand, no guarantee that areas where private property prevails will not rot from within, because of the free-rider problem discussed above. There is no invisible-hand process to ensure that a religion or any other compelling ideology will always be there to prevent cultural decline. In the extreme, there could be such discord with respect to values that the model sketched early in this paper could degenerate from a state of anarchy in the sense of "no government" to anarchy in its literal sense, meaning "without rules; chaos." As an individual, all one can do is exercise free will on behalf of the values and ideology in which one believes. One recalls the famous remark attributed to Jefferson: "Eternal vigilance is the price of liberty." (Since the family has for ages served as a repository of cultural values, the importance of sound family law—the rules governing marriage, divorce, and children—should also be mentioned in this context.)

One should not underestimate the capacity of "vigilance" and informal sanctions, plus simple inertia,[39] to support a group's functional traditions. After an elaborate study of the matter, Robert Sugden (1986, p. 177) went so far as to conclude simply: ". . . the morality of spontaneous order is conservative." A *strength* of a nongovernmental system may also be that, if a disagreement about fundamental values does arise, no one has a state readily available through which he can try to impose or subsidize his views.

Implications

As noted in the introduction, viewing law as a discovery procedure yields "some interesting consequences that are not so obvious." An

[39]Ibid.

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exhaustive discussion would require a separate paper, but a few of these consequences are highlighted below.

Tort and Contract Law

In combination with the use of injunctions, "strict liability" is often said to be "the" Austrian position on tort issues. A policy of strict liability means assigning responsibility to a party for any damages emanating from his person or property, regardless of whether he was at fault. If Party A is damaging Party B, making A subject to an injunction forces A to bargain with B if he wants to continue his activity. A and B can then use their knowledge of "circumstances of time and place" to arrive at a mutually agreeable outcome. If B insists on compensation that exceeds the subjective value that A places on the activity, it is evidence that the activity is not worthwhile. A flat rule of strict liability, which leaves judges with little discretion, also adds to the certainty of the law, thereby further helping individuals to coordinate their actions.

The more thoroughgoing Austrian analysis in this paper casts doubt on what has been previously thought to be "the" Austrian position. It is well known (Cooter and Ulen 1988, pp. 367–71) that the efficacy of a policy of strict-liability-with-injunctions is doubtful if bargaining costs are extraordinarily high, and if plaintiffs in tort cases can provide protection for themselves at a much lower cost than defendants. To be sure, judges who follow a doctrine that imposes liability only if the defendant is judged to have been at fault cannot know all the circumstances of time and place that are relevant to a neoclassically efficient outcome. But these judges might still generate results that consumers of court services in a private legal system would sometimes prefer ex ante to strict liability. A thoroughgoing Austrian position would thus maintain that the extent to which strict liability prevails should be the object of a discovery procedure. The issue could be resolved in a market for court services.

A similar conclusion must be drawn in analyzing the use of a remedy of "specific performance" as opposed to payment of compensatory damages in cases of breach of contract. Austrians often favor specific performance because it forces someone breaching a contract to create (approximately) the subjective experience that the plaintiff expected to be forthcoming when he signed the agreement. As is true of strict liability, adherence to such a doctrine also creates an element of certainty in relationships; this certainty helps individuals coordinate their actions. Suppose, however, that a party almost fulfilled a contract—almost, but not quite. For example, suppose Party A built a beautiful mansion that was almost exactly what Party B

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specified in their contract—almost, but not quite. For example, suppose Party A built a beautiful mansion that was almost exactly what Party B specified in their contract—almost, but not quite. Suppose also that B paid for the house in advance. What if specific performance would require A to incur hundreds of thousands of dollars of costs to rebuild the entire mansion? A private court might nix specific performance and instead ask A to pay compensatory damages to B. To be sure, no judge would know the "correct" damage award that would generate precisely the "proper" subjective experience for B, but there are undoubtedly occasions when compensatory damages would be preferable to all parties concerned, especially if high bargaining costs existed to hinder A and B from negotiating a settlement among themselves. Again, the matter could be resolved in a market for courts. Thus, in comparison to a court that imposed a remedy of specific performance, both A and B in the example above would prefer a court that set compensatory damages at an amount that was more than the loss of subjective value to B from the breach, but less than the cost of rebuilding the mansion.

Consider one additional issue: In the absence of explicit contracts on the matter, should the law treat bank deposits as bailments, thereby mandating 100 percent reserve banking? Or should fractional reserve banking be permitted? The common law and modern legislation have not treated deposits as bailments. Given the opportunity costs of holding bank reserves, one might not expect a 100 percent reserve system to prevail even under privately articulated law, but one cannot be sure in advance. The outcome would also depend on consumers' desires for deposit insurance and on whether treating deposits as bailments turned out to be a low-cost way of providing at least some of the insurance demanded.

The Relationship between Law and Morality

It should be clear from what has already been said that, from the perspective of this paper, no fixed line can be drawn to separate law and morality. Morality refers to certain rules that ought to guide human conduct, regardless of whether these rules are articulated and enforced in a formal way. Law, on the other hand, is the formal enterprise of making certain rules explicit and then seeing that some attempt is made to enforce them. At what point should lying be subject to legal sanctions? Not when ordinary schoolchildren tell falsehoods to each other during recess. Should the law regulate abortions at some point? Firm answers to such questions presuppose knowledge that no individual possesses. The answers depend on complex circumstances concerning the fact patterns of different

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cases, people's values and preferences, and the costs of operating various types of legal enterprises. The questions can be addressed in two basic ways: by some degree of central planning, or through a market process. The latter at least offers the prospect of uncovering the information that is relevant for deciding when it is worthwhile to resort to the formal enterprises of the law.

The Relationship between Individual Rights and Utility

The perspective of this paper has been one of natural rights and natural law, in the sense that rights and the law are viewed as existing independent of the will of some sovereign power. In this sense, the view of the law here is diametrically opposed to that of legal positivism. On the other hand, this paper has not viewed rights and the law as fixed along the lines of an absolutist model. It must be stressed that this approach is different from viewing them as arbitrary.

In a broad sense, rights and the law are seen here as the product of interaction between individual preferences and ever-present constraints on the information and other resources people can possess or acquire. Rights and the law can thereby be seen as social outcomes in the same sense as prices and quantities. They would not, however, be likely to change anywhere near as often, and could, of course, be expected to command a stronger emotional allegiance. From a thoroughgoing market process perspective, neither prices and quantities nor rights and the law are seen as arbitrary.

Speaking more concretely, the paper emphasizes that a deep respect for rights of private property (and the liberty they secure) is the *sine qua non* of the system under discussion. At the same time, the paper has argued that in some cases a process of articulating and enforcing a complete set of private rights is probably too costly. As in other matters, resource scarcity would constrain what people would choose to do.

In an ultimate sense, then, the moral-philosophical outlook here is one of a system of rights with a utilitarian basis that would help individuals coordinate their respective plans and generate a spontaneous order. The system would do this by unearthing and spreading information about not-yet-exhausted gains from trade. This is not to say, however, that individuals would at all times be led to maximize either their own or others' utility. Recall, for example, that one key feature of a competitive discovery procedure is negative feedback. The main reason for relying on a discovery procedure and for eschewing a direct, satisfaction-maximization version of utilitarianism would

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again be that no one can ever know enough to make "the good of Mankind" an ever-present, operative goal.

We thus fall back to an "indirect" (or "rule") utilitarianism in which we hit upon certain, somewhat contingent guidelines or "rights" to influence how we act.[40] Since another essential aspect of the system is having individuals use their separate bits of knowledge to pursue their separate purposes, these rights would tell people what they must *not* do, rather than what they must. Given our ignorance, there would always be cases where letting our choices be influenced by the received rights and rules would seem harmful, but once more, we would have to put aside our temptations and conceits and put more faith in a process than in our ability to plan a whole set of outcomes in advance. An emotional attachment to "rights" that exist independent of direct, short-run considerations of utility would thus be a vital aspect of the system and, hence, of the freedom it involves. It should be remembered that in an indirect, overall, long-run sense, these rights *would* have instrumental value. The paradox is that the more we viewed them as instruments, the more our constructivistic impulses and conceits would tempt us to abridge them for some immediate gain.

Anarchism versus Libertarianism

Let us define "strict" libertarianism as a politico-economic system in which the legal rights to property and contract would be absolute. In such a system, a person would have a legal right to use, or not to use, his property (including himself) in any way he liked, as long as he did not infringe on others' rights to do the same. A private owner of a tropical island, for example, would be legally entitled to forbid a desperate castaway from setting foot on his property. Let us define "ultrastrict" libertarianism as a version of strict libertarianism in which "infringements" of property rights would refer only to physical invasions, such as theft, or to certain other actions deemed equivalent to theft, such as fraud. Under ultrastrict libertarianism, a person could not, for example, claim even a limited property right to a reputation, as can be done under modern Western law; ultrastrict libertarianism would thus rule out laws against slander and libel.

Many discussions of libertarianism take up one area of life after another, purporting to show how various problems could be dealt with through the actions of private individuals, subject only to gen-

[40]The terms "direct"and"indirect" utilitarianism were introduced in Singer (1961). The role of imperfect information in leading to indirect or "rule" utilitarianism is discussed in Hayek (1976, chap. 7).

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eral rules of property and contract. Anarchism is then viewed as an extreme form of libertarianism in which even the legal system would be governed by the actions of individuals vested with (absolute) private rights.

This paper has cast doubt on the germaneness of such a perspective. As previously discussed, the legal rights to property and contract would probably not be absolute in a private legal system. To some extent, then, the system might not be purely libertarian. Nor would a private legal system necessarily consider a person's legal rights to be infringed only if he (or his tangible property) had been physically invaded or defrauded. In the private legal system of Celtic Ireland, for example, jurists not only asserted an eminent domain power; they articulated laws against libel, made allowances for physical invasions of property in certain emergency situations, and even allowed certain relatives of a property owner to veto the sale of his land (Peden 1977). To be sure, the Irish system showed a deep respect for private property, and perhaps some of these rulings would have been modified had the system lasted even longer than it did, but the rulings illustrate the nonabsolutist character of an historical episode worthy of further study.

People can, of course, try to persuade others, including the judges in a future private legal system, to adopt a philosophy of strict, or even ultrastrict, "anarcho-libertarianism," just as they can try to persuade today's legislators to enact a particular combination of policies or, for that matter, persuade private enterprises to sell particular products at particular prices. The problem is that people in whatever politico-economic system is under discussion are faced with incentives that are not systematically consistent with the particular actions being asked of them. Thus, if an ideological movement succeeded in bringing about a pure state of anarcho-libertarianism (as improbable as that seems), this result would probably not constitute a stable politico-economic equilibrium. This is not to denigrate the general power of ideas and ideologies to sway events, but simply to say that there is no invisible-hand mechanism that can be counted on to direct the content of ideologies so as to make a very specific set of social outcomes likely to persist for an extended period.[41]

Conclusion

By focusing our attention on processes of discovery, Hayek has given us a way of looking at the world that has only begun to be

[41]For a line of argumentation that is not inconsistent with the foregoing, see Friedman (1989, chap. 31).

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appreciated. The notion of a discovery process has long been present in the study of law, but in recent times the idea has been drowned by the flood of writings espousing various forms of legal positivism. Now, though, through the midwifery of Austrian economics, the concept of a discovery procedure has a chance for rebirth among legal scholars, albeit in a new form. Previously, legal scholars have spoken of the discovery procedure of the common law, whereas a thoroughgoing Austrian approach would have us seriously consider the potential of a private legal system to uncover rules and institutions conducive to spontaneous order. In this regard, this paper has suggested that Hayek himself may not have pushed the analysis sufficiently far. Even if one rejects a private legal system, one can perhaps appreciate the way in which the exercise of conceptualizing it has pointed toward certain general principles that can help guide the resolution of legal issues. Among these principles are nonabsolutism, a long-run indirect version of utilitarianism, natural rights that are resistant to immediate utilitarian concerns, and legal doctrines manifesting respect for the division of knowledge in society.

While all the criticisms of a private legal system made by Landes and Posner and others merit much more discussion, at this point the argument for such a system seems weakest in the following respects: (1) Especially in areas threatened by external forces, such as predator states, one cannot dismiss lightly the concern that protection agencies may constitute natural monopolies; (2) there may be public-good/prisoner-dilemma situations such that even those wary of government powers would deem a state to be a necessary evil; and (3) the process that is to guide the formation and sustenance of norms and values does not inspire great confidence. As previously discussed, this last concern can be seen as a special case of the second concern above.

One can favor a stateless system, believe it could be reasonably stable for an extended period, and still conclude that, like it or not, the system would eventually break down or evolve into something else. The same can be said with regard to a system of limited government. Nothing lasts forever, and to arrive at this or any other truism one does not need much of a discovery procedure.

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Disasters and Market Response

George Horwich

The post–World War II era has seen an enormous output of scientific research on the mitigation and behavioral response to disasters, both natural and otherwise. Over this same period, world gross economic product has surged, sparked by the performance of market-oriented economies in the West and Far East. An attempt to blend some of the insights of social scientists on disasters with the record of market-driven economic activity is, I think, a potentially useful exercise whose findings can simultaneously inform, constrain, and enhance the role of government in disaster management.

In this paper, I will begin with a working definition of a disaster followed by an analysis of the American response, particularly that of the U.S. government, to the oil-supply disruptions of the 1970s and 1980s. The oil shocks, which have been thoroughly studied in the economics literature, readily qualify as a disaster under my definition. They also serve as a convenient reference for the market adjustments that follow an economic shock and to which a variety of government responses is possible. Finally, since the energy shocks have been the major disturbances to the post–World War II economies, it seems fitting that an economic analysis of disaster management begins with a re-examination of experience during the energy crises.

My assessment of the American government's management of the oil price shocks is not very positive in terms of either efficiency or

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The author is Professor of Economics and Burton D. Morgan Professor for the Study of Private Enterprise in the Krannert School of Management, Purdue University. The research for this paper was conducted during the author's tenure as a collaborating scientist at the Oak Ridge National Laboratory. An earlier version of the study was presented at the Milano Politecnico University in Milan, Italy, November 10, 1989. The author is indebted to the late Martin Katzman and to David Weimer for detailed and insightful comments on an earlier draft. He has also had the benefit of discussions on this subject with Conrad Chester, T. Randall Curlee, Lawrence Hill, Donald Jones, and Milton Russell.

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equity criteria. The remainder of the paper will develop the relevance and implications of this conclusion for the government's role in a wide variety of natural and manmade disasters.

Disasters Defined[1]

We take a disaster to be a loss of resource value beyond some socially specified level. For given physical quantities of resources, value is determined by the sum of prevailing individual attitudes as expressed, in the first instance, in market prices. Where prices are not available, as in the asset value of human resources, we rely on indirect market evidence such as personal income properly capitalized. In this context, market value, whether directly or indirectly observed, can be modified by political consensus, as in attaching above-market value to individuals thought to be unfairly disadvantaged or to regions having special ecological or national security attributes.

The threshold loss of resource value that constitutes a disaster is established by consensus and will incorporate a "taste" factor and tend to vary positively with national income and with the interval of time and space over which it occurs. For example, in the aggregate, 50,000 U.S. traffic deaths a year in a population of 250 million over an area of 3.5 million square miles are not usually perceived as a disaster. But several hundred deaths in a commercial airline crash are almost invariably so regarded, owing, in part, to the very brief interval of space and time over which they occur.

The time frame is relevant in evaluating planetary disasters, such as the onset of an ice age or the heating of the upper atmosphere that results from deforestation or the burning of fossil fuels (the "greenhouse" effect). If such events occur at a sufficiently gradual rate, they need not impose disaster-level resource losses in any given time period. Suppose, for example, that New York City were being flooded by a rise in sea level induced by atmospheric warming and consequent melting of the polar ice caps. It is at least possible that the city and its properties would be inundated at a rate no greater than the rate at which its structures normally depreciate. In that event, the city's physical capital could be gradually rebuilt in more viable sites without any sudden, disruptive, or severely uncompensated loss of market value.

Valuation of a resource may involve costs external to the event itself. Thus, while 50,000 annual traffic deaths may not generally be

[1]This section draws on material jointly developed with F. T. Sparrow.

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seen as a disaster, an equal number of war casualties, even though spread over a number of years and a wide geographic area, might well be in the disaster category. Associated with war losses are possible reductions in the nation's security, prestige, economic and political viability, etc., the valuation of which must be added to the immediate loss of human life.

The existence of an associated larger cost is also relevant to the assessment of the seven deaths from the cyanide-lacing of the pain reliever, Tylenol, in 1982. The disaster lay in the potential threat to public safety, not only from Tylenol capsules that had been tampered with, but from all food and nonprescription drugs distributed on open shelves throughout the country. Similarly, the Three Mile Island nuclear plant accident in 1979, which has cost no lives then or since, became an immediate national disaster by casting a shadow of uncertainty over the safety and reliability of the entire nuclear power industry then and in the future.

Up to a hundred or more deaths occur annually in U.S. coal mining and are treated in the aggregate as a routine nondisaster event. Most of the fatalities are isolated incidents in various phases of transporting the coal. Occasionally, however, a small group of miners is trapped underground in a mine accident that becomes a media event and, indeed, a national disaster. Such episodes, of course, span a very brief interval. But a further cost, which also characterizes the loss of commercial airlines, is the expected cost increases that the companies, and perhaps the entire industry, may have to bear. A mining company whose safety record is worsening will have to pay higher wages and install expensive safety equipment; an airline whose safety level falls may also incur costs of new equipment or lose sales both for itself and the industry.[2]

Finally, we note that this view of disasters has its counterpart in the recovery stage. The concept of resource value is useful, since it permits the definition of recovery goals in rather specific and easily understood terms.

[2]Verification that this occurs in the airline industry comes from a study by Andrew Chalk (1987). He took manufacturer's share prices as the market's assessment of an airplane's safety. In a sample of 72 crashes from 1966 to 1979, Chalk found that when media reports indicated that the plane's design may have been a cause, the manufacturer's share price dropped 3.8 percent on average. When reports showed no such causal connection, share prices were unchanged. Similar findings are reported by Rubin, Murphy, and Jarrell (1988) for products recalled for safety reasons by the Consumer Product Safety Commission. In a sample of 31 firms involving 48 recalls from 1977 to 1981, the share prices of affected firms dropped an average of 6.9 percent.

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The Oil Shocks

World oil prices more than quadrupled in the fall of 1973 and then more than doubled from late 1979 to early 1981. Each of these increases reflected a sharp drop in the production and availability of oil. In response, the total output of goods and services in the industrial countries fell, relative to trend, by tens of billions of dollars. Depending on the discount rate used, the imputed loss in the value of national resources was a large multiple of the reduction in gross national products. In this very real sense, the energy crises imposed a state of disaster on world economies.

If we assume that some or all of the oil supply curtailment was permanent, overcoming the disaster and restoring the value of resources required a massive economic adjustment. It was necessary to find and produce alternative sources of oil, to substitute cheaper alternative sources of energy, and to use less energy of any variety in producing the national outputs. In the short run, known techniques and existing alternative energy supplies could be drawn upon to produce the same or similar goods and services. In the long run, less energy intensive technologies and new energy sources would come on stream accompanied by a vast reallocation of resources and by transformation in the kinds of goods and services produced.

In the United States the adjustment was essentially driven by market forces in response to freely fluctuating prices. The force of the long-run adjustment is attested to by a roughly one-third increase in real GNP ($1 trillion in 1985 prices) between the mid-1970s and mid-1980s without any increase in total energy use. The short-run adjustment, however, from 1973 to 1981, was severely constrained by a rigid regime of government-imposed price ceilings and mandatory allocations of both crude oil and petroleum products. Most economists who studied this era concluded that government's management of the energy crisis increased the scale and scope of the "disaster" and delayed the longer-run adjustment.[3]

Price ceilings were imposed on the sale of domestically produced crude oil and refined petroleum products.[4] The ceilings were a complex set of regulations that varied with respect to petroleum categories and were subject to frequent change. From 1973 to 1981, they essentially succeeded in maintaining the average of U.S. petroleum

[3]See Arrow and Kalt (1979); Couts and Horwich (1982); Ford Foundation (1979, chaps. 1 and 5); Horwich and Weimer (1984); and Lane (1981).

[4]The material in this paragraph and in the remainder of this section is drawn from Horwich and Weimer (1984, chaps. 2 and 3).

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prices at below world levels—crude oil by about 30 percent and petroleum products by about 10 to 15 percent.

The price ceilings kept U.S. domestic production of crude oil at a lower level and domestic demand at a higher level than either would have been at world prices. Since U.S. controls could not be effectively applied to the world market, the excess of domestic demand over supply spilled freely into the world market where it took the form of additional imports. On average, the controls are estimated to have raised U.S. petroleum demand (net of domestic supply) 12 to 14 percent, resulting in a 33 percent increase in U.S. imports throughout the control period.[5] Since the U.S. is the world's largest consumer of oil, its price ceilings undoubtedly had a significant impact in raising the world price of crude oil.

In the U.S. domestic market for refined petroleum products, such as gasoline and jet fuel, most products are not traded internationally. The market for such products was thus essentially domestic. The controls had the effect of maintaining the ceiling prices below the market-clearing prices. This effect occurred even though product prices were permitted to increase to reflect increases in crude oil costs. Prices could be raised only at periodic intervals, however, often some weeks after an increase in crude prices. Other component costs, such as capital and interest, were not eligible for pass through to the product prices; although labor costs were eligible for pass through, there were limitations on how those costs could be allocated among the various products of a refinery's output.

Perhaps the most serious flaw of the controls was their failure to permit refinery profit margins, and hence prices, to change in response to changes in supply and demand. Temporary changes in the margin and the price, often a cent or two or less per gallon, are the signals and the incentives by which petroleum products are allocated to their myriad uses throughout the economy. Freezing the margin over long periods effectively destroyed the market mechanism and created severe and lasting imbalances in distributing products geographically and among industries and consumers.

When ceiling prices are held below the market-clearing level, not only is there unsatisfied or excess demand in the market, there will be a shadow price—i.e., the actual value consumers place on the existing supply—that exceeds both the ceiling price and, as a rule, the market-clearing price. The combination of excess demand and extraordinarily high shadow prices motivated consumers to devote valuable time and resources to searching for supply, often by expend-

[5]See the data in Horwich and Weimer (1984, p. 75).

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ing limited fuel supplies, queuing, and the like. Because consumers could not offer a market price above the ceiling, moreover, their efforts failed to induce any additional supply in the aggregate. Suppliers, meanwhile, faced with rising costs many of which could not be passed on, adapted by reducing the quality of their product. The octane rating of gasoline fell, and hours of operation of retail stations throughout the week were sharply reduced. What had been a highly efficient, dynamic, and dependable national fuel distribution system became sluggish, uncertain, and inflexible.

Adding to the distortions caused by the price ceilings was a vast network of government mandatory allocations of both crude oil and petroleum products. Large refiners with supplies above the industry average were required to transfer oil to small refiners, who were also subsidized disproportionately in their imports of oil at prices below the world level. Under a "supplier/producer freeze," all nonretail sellers of crude oil and products were required to service customers in proportion to the sales of an earlier base period. Exceptions were granted under a "priority" system that allocated additional supplies to agriculture, residential heating, and the emergency services sector. Under "exceptions relief," approved but self-certified "hardship" cases received transfers of oil or cash, often of epic proportions.

The incentive effects of the mandatory allocations were perverse in the extreme. Companies that had anticipated the oil price shocks by stockpiling oil were forced to share their inventories at below free-market prices with those exhibiting no such foresight or resourcefulness. Historical-use allocation under the supplier/purchaser freeze ignored the rapidly shifting distribution of population among the states and regions of the country. It also discouraged buyers from seeking alternative sources of supply and sellers from accepting new customers, whom they were automatically required to serve indefinitely.

The priority ranking of classes of buyers and the subsidies to small refiners were based on intuitive unsubstantiated criteria as to what an optimal or equitable allocation might be. Farmers, who were believed to have little flexibility in harvesting their crops, were observed on a number of occasions reselling their generous allotments of diesel fuel on the open market. Small refiners, who complained endlessly of their supposed inability to compete in the world market with larger companies for declining supplies of crude oil, were in fact only reflecting the high elasticity of demand for the heavier products (boiler fuel, low-grade heating oil) that they typically produced. Thus, when petroleum prices rose in disruptions, the demand for their products, for which there was a number of close

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substitutes, fell more than the demand for products of larger refiners who generally produced lighter products, such as gasoline, for which substitutes were fewer and demand elasticity much lower. The relative decline in demand for small refiners' products in turn dampened their demand and willingness to bid for crude-oil inputs. Nevertheless, some 50 or 60 small refiners, particularly those producing fewer than 50,000 barrels per day, received subsidies that maintained them in the industry at net returns on their investment of 20 to 50 percent per year throughout 1975–81.

Throughout the energy crisis, the interventions of the U.S. government were not based on a rational set of goals that reflected the comparative advantages of private and public decisionmaking. In the absence of clearly revealed external costs and benefits, it is extremely rare for an outside entity to be able to raise the efficiency with which individuals pursue their exchanges through the mediation of free-market prices. Only those at the basic level of the firm and household are likely to know (often through a process of trial and error) what buyers desire and how best to provide it.

Although small refiners appeared to be unduly vulnerable and farmers were feared to lack sufficient access to fuel at a critical time, it was in fact impossible for government to influence the outcome with better information than the participants themselves already had. Small refiners, and only small refiners, understood clearly that in emergencies the low demand (reflecting a high demand elasticity) for their products did not justify aggressive bidding and predisruption contractual arrangements that would have augmented their efforts at oil acquisition. If farmers' harvesting plans were based on market considerations, the price of their final products would have motivated *and financed* an all-out attempt to secure fuel when, as, and in the amount the harvest required. Still, if government was willing to supply fuel to small refiners and farmers at prices well below market, they accepted it unhesitatingly.

As a rule, government's focus in supply shocks should be on broad goals of aggregate stability, national security, and social equity. None of these goals is likely to be served by individual market interventions that require information the government does not possess and that produce innumerable unintended repercussions that, overall, destroy market efficiency. The price ceilings on crude oil and petroleum products were intended to keep petroleum affordable—particularly to low-income consumers, to limit the windfall gain to domestic producers, and to dampen the general inflationary impact of the disruption. While domestic prices of crude oil were indeed main-

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tained below the world level, the U.S. regulations, as we have seen, raised the world and U.S. price in some degree.

The windfall that would have gone to producers went instead to refiners, particularly small (but wealthy) ones who, by market standards, were inefficient and whose capital gain bore no obvious relation to commonly accepted canons of social equity. Meanwhile, the price ceilings and loss of windfall by producers discouraged the production of U.S. crude oil. In the product markets, the price ceilings eroded the functioning of the entire fuel distribution system. There is no evidence that under nonprice allocation (which rewards aggressive search activity and political influence—attributes more characteristic of the wealthy than the poor), low-income households were able to get even their proportionate share of the reduced supplies of fuel.

The attempt to control general inflation by capping a single group of prices simply diverts funds to other markets where prices rise disproportionately. In fact, by reducing the efficiency of the energy sector, the controls reduced total real GNP, thereby increasing the inflation rate and eliminating jobs of many marginal and low-income workers. The final irony is that despite the price ceilings and heroic transfers aimed at limiting their profits, the integrated American oil companies enjoyed above-average earnings from their domestic operations during the emergency era. A major cause of this was the restrictions on entry of new firms and the general decline of competition fostered by the government's rigid price ceilings and mandatory allocations.

Government's macroeconomic policies were as perverse as its microeconomic interventions. Almost without exception, central banks of the industrial countries responded to the inflations of 1973–74 and 1979–80 (part of which were induced by the energy shocks) by pursuing tight money policies that reduced real GNP and employment.[6] Monetary tightness is normally an appropriate offset

[6]Mork and Hall (1980) attribute one-fourth and Tatom (1981) about one-fifth of the United States's 1974–75 inflation to the rise in energy prices. For 1979–80, Tatom identifies one-fourth of the inflation as caused by energy prices. The rise in the general price level attributable to a rise in a component price is due, of course, to a simultaneous net reduction in aggregate supply—in this case caused by a decreased supply of a widely used energy input. The disturbance is analogous to a crop failure that reduces aggregate output in some degree and, for given total money expenditures, causes the general price level to rise.

See Hafer (1981) for a comparison of monetary growth rates among industrial countries during the energy disruptions. For criticisms of the nonaccommodating posture of monetary policy, in addition to Hafer, see Phelps (1978), Carlson (1979), Solow (1980), and Gordon (1984).

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to prior excesses of monetary growth, but as a rule, should be pursued gradually. In light of the massive reallocation of resources occasioned by the rise in energy prices, the monetary restraint should have been tempered even more than otherwise. In the opinion of some economists, the loss of output resulting from monetary contraction exceeded that directly caused by the rise in oil prices (Bohi 1989, chap. 7).

Disasters in General

The oil shocks differ, of course, in important respects from natural disasters or manmade disturbances such as strikes, riots, and war. They differ in magnitude, geographical extent, diversity of economic impact, loss of human life, degree to which capital is physically destroyed, and degree to which public goods, such as highway use and utility services, are curtailed. Yet all share the common feature of a decline in resource value to which a specific mix of government and private-sector responses is appropriate. As far as possible, these responses should entail least-cost supply solutions that are responsive to consumer preferences. The fact that assets in a natural disaster, for example, are physically destroyed and need to be reconstructed, whereas in an oil shock they are devalued and need to be replaced or transferred to other sites and uses, does not itself imply that private markets can or should play a major role in one case but not the other.

The argument is frequently made that uncontrolled markets cannot effectively respond to very large or catastrophic disturbances.[7] But in the noncommunist countries, markets have played the dominant role in the economic demobilizations and recoveries from the wars of this century; markets have also been important in the mobilizations. Even before the fighting begins, shifts of demand from civilian to wartime output impose an immediate massive loss in the value of resources that are, for the moment, in premobilization uses and locations. Only when the mobilization is completed do the resources recover their value. Although industrial mobilizations generally circumvent the market, proceeding by centralized commands, wartime reallocations of the U.S. civilian labor force have been accomplished largely by freely fluctuating wages. In World War II, tens of millions entered the labor force or changed employment, often traveling hundreds and thousands of miles, directed only by wage movements.

[7]For the problems involved in the restoration of markets following nuclear cataclysm, see Hill (1987) and Cantor, Henry, and Rayner (1989).

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The most impressive manifestations of the power of the market have occurred in the postwar aftermath; for defeated countries, these manifestations occurred in a setting of physical and organizational ruin and devastation. But even a victorious nation, such as the United States in 1946, underwent a colossal economic transformation guided by free-market prices without any trace of centralized direction or allocative authority.[8] In that year real U.S. government spending fell by 77 percent— from 37 percent of GNP to 10 percent; hundreds of thousands of bureaucratic personnel literally fled the capital. Eight million troops were released from the armed forces and perhaps a fourth of the nation's 53 million civilian workers were abruptly released from wartime employment to seek peacetime pursuits. Real GNP was totally restructured and, in the aggregate, fell by 11 percent, but 2.4 million net additional civilian jobs were generated. Unemployment rose from an abnormal wartime low of 1 million in 1945 (1.9 percent of the labor force) to only 2.3 million in 1946 (3.9 percent of the labor force).

As remarkable as the American postwar adjustment was, the market-driven recoveries of West Germany and Japan border on the miraculous.[9] Their extensive loss of capital, infrastructure, and life is, of course, more analogous to that of natural disasters—although much more vast in all dimensions, including also geographical extent, diversity of economic impact, and loss of public goods. In both countries, reconstruction and sustainable independent recovery began only with the removal of price ceilings imposed during the wartime inflations. Centralized government played no significant role in directing postwar economic activity; it confined its policies to macroeconomic stabilization (including currency reform in West Germany), provision of public-goods infrastructure, and social programs (including land reform in Japan). An even more limited government presence characterized the recovery of the confederate South following the American Civil War. The economic chaos wrought by the Bolshevik Revolution of 1917 ended only in 1921–24 under the New Economic Policy in which the Russian government restored property rights, legalized markets, and reintroduced money.[10]

[8]See Horwich (1989) for the data in this paragraph, including the catalytic role played by high levels of real cash balances.

[9]The material in this paragraph is drawn from Hirshleifer (1987, chap. 1). See p. 81, n. 16; p. 83, n. 38; p. 85, n. 72; and p. 87, n. 119 for Hirshleifer's major sources.

[10]Mancur Olson (1982) attributes the success of postwar or postdepression economies to the tendency of severe shocks to eliminate the restrictions, protections, and other market-restraining forces that build up in mature or nondisrupted economies.

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One may believe that market activity is the only route to long-term recovery and growth while one, nevertheless, remains skeptical that markets can play a significant role in predisaster planning and the immediate postdisaster response. I think this skepticism is unwarranted and overlooks what markets and the private sector can do and have already accomplished in disaster prevention and relief. It also rests on an exaggerated notion of the capabilities of government and quasi-government organizations, whose responses to disasters have often been ineffective or perverse.

Individual and Organized Behavior in Disasters

Perhaps the major finding of disaster research by sociologists in this century is the discovery that individuals and communities rarely panic in the aftermath of natural disasters.[11] Even when the damage is extensive and there is considerable loss of life, survivors tend spontaneously to marshall their remaining resources and adapt to the new environment. It helps, of course, that even when 10,000 people die and an equal number are rendered homeless, the overwhelming majority in a total urban population of, say, 100,000 remain alive and in their homes. But even when the ratio of victims to survivors is far less favorable, Dynes reports that panic and anti-social behavior, such as looting—other than by "outsiders"—is extremely rare in natural disasters. Indeed, altruistic behavior is more typically the norm, as reported by both sociologists and economists.[12]

Dynes and others make the further point that individuals at the household and community level not only respond quickly and adaptively to a disaster, but are the only ones capable of doing so. Intimate firsthand knowledge of the location and quantity of remaining food supplies, of the best alternative sources of housing and energy, of the usable alternative roadways and means of transportation, and of the available medical care (if indeed very much is needed, since few of the injured may survive long enough to require it)—all of this will be known in the greatest detail and applied most creatively at the grassroots level.

The application of this knowledge occurs within what Dynes (1983, p. 659) designates an "emergent human resources model." Postdisaster relationships gradually develop among those with a

[11]See Dynes (1970, pp. 7–8); Dynes (1983, pp. 658–59), and references cited there; and Drabek (1986, pp. 136–37).

[12]On looting behavior, see Dynes (1970, p. 8), and Drabek (1986, pp. 145–46, 181, and 231–33). In civil disorders, looting, of course, may be the principal activity. On altruistic behavior, see Dacy and Kunreuther (1969, chap. 3), and Hirshleifer (1987, chap. 4).

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stake in the disaster operations—victims, rescuers, providers of services of all varieties. While the social and economic relationships develop spontaneously, they do so within the framework of previous relationships best known to the participants themselves. It is impossible, in Dynes' opinion, for the optimal postdisaster structure and responses to be imposed by higher authorities or outside agencies through a command and control process. The common assumption that postdisaster needs and solutions are self-evident—rescue, clearance of debris, provision of certain "essential" services—is not borne out by a far more complex reality.

Cuny (1983, chaps. 7–8), a disaster relief practitioner, documents the failures of foreign governments and agencies, usually voluntary and charitable, in responding to disasters in third world countries. Rarely do such entities have the knowledge of local conditions to make an effective response. Even brutally poor people, for example, have tastes and preferences as to the kind of housing they want and can afford to maintain—as determined by their incomes and cultural and religious traditions. Well-intentioned outsiders, lacking systematic feedback from the recipients, are unlikely to come close to anticipating or satisfying those tastes, no matter how generous their motives. The optimal timing with which housing construction is undertaken will depend on the local climate and the circumstances of the disaster; doubling up with one's relatives whose housing still stands may be the preferred option until other needs are met. Nor will local manufacturers, farmers, merchants, and providers of services greatly appreciate the depressed prices and loss of sales that donations of outside goods and services create.

Cuny's most damaging criticism of charitable organizations and foreign governments is that they not only lack adequate knowledge for meeting local needs, but they lack the incentives for acquiring that knowledge (Cuny 1983, pp. 145–47). Charitable organizations must perform in a way that maximizes their own revenues. This usually means undertaking highly visible relief efforts within a very limited time (often as a requirement of their charters). Foreign governments, particularly democratic ones, are necessarily political and must please constituents who also want fast, visible results and have little patience for the drawn-out indigenous procedures that are likely to be most beneficial in disaster-stricken countries.

In spite of these insights as to the diversity of consumer preferences, the importance of optimal supply, the inefficiency of centralized control, and the fact that individuals typically are not disoriented and are quite capable of rational responses in the postdisaster period, the sociology literature does not address the role of markets in disas-

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ter prevention or the immediate recovery. Cuny (1983, p. 200) is quite explicit that prices must be held constant in the disaster aftermath—effectively preventing the operation of the market—while the community responds, often with the assistance of outside experts. But markets are precisely the institutions within which economic responses are ordinarily expressed: Individuals and families wanting goods and services signal their desires through price offers to which suppliers anywhere in the world may respond. In the immediate aftermath of a disaster, economic activity may, of course, be limited to self-help, as in the Robinson Crusoe economy, or, where exchange is possible, to barter. That is, the postdisaster tasks are performed by individuals in exchange for goods and services provided directly by others within the community. It is perhaps clearer in this context that the "helpless victim" model of disaster behavior has a limited empirical basis.[13] Indeed, the spontaneous self-organizing response by citizens and neighbors in barter activity may raise morale and productivity significantly above their immediate postdisaster levels.

Markets, however, operating through a common medium of exchange and prices, are an ongoing link between consumers and producers that potentially offers, relative to barter, a vastly increased quantity and variety of goods and services tailored to a multiplicity of tastes and produced by a wide range of skills and equipment at minimum attainable cost. Although many of the developing countries and most communist countries lack, or are without free access to, functioning markets, the rest of the industrial world—and in particular the urban areas—is unlikely to be totally detached from markets at any time predisaster or postdisaster.

Where markets are viable, even to a limited degree, preventing prices from moving denies consumers the free, self-selected expression of their preferences and denies producers the information that, in their supply decisions, they can weigh against the new conditions of scarcity and cost. The results of price fixing—for the whole range of goods and services sought in the disaster aftermath—are entirely comparable to the malfunctioning of U.S. energy markets during the regulatory period. Prices held artificially below market-clearing levels reduce the amount supplied, raise the quantity demanded, and drive the unsatisfied demand into sub-optimal alternatives. Simultaneously, shadow prices move well above market clearing and

[13]An important exception to the self-help and barter tendency seems to occur in parts of the Third World, where traditional rural economies suffer from food deprivation and famine. See Sen (1981); in particular, his discussion on the "entitlement" to food and the passive behavior accompanying it in Bengal in 1943 and Ethiopia in 1974.

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promote search activity whose cost far exceeds that of information provided by market prices. Because search cannot raise market prices, it also fails to evoke any net additional supply. Available supply, meanwhile, tends, in the shortage market, to deteriorate qualitatively.

Government, Markets, and Disaster Management

None of the foregoing implies that there are no problems with the functioning of free markets in postdisaster economies or that the resurgence of markets will be automatic. Not the least of the problems is the inability of lower income households to join in market activity following catastrophic loss of their assets and incomes. Sharp price increases may also create general social unrest, although, in the industrial world, the increases are less likely to occur or last very long when the disasters are localized—as they usually are. In fact, there is evidence that in such circumstances, price increases are frequently moderated by spontaneous, voluntary restraint of buyers in exercising their demands.[14] To deflect criticism, suppliers may also limit price increases, but that makes the seller a nonprice allocator, which is not economically efficient.

A further complication in natural disasters or war is the destruction of transportation and communication infrastructure—roads, bridges, harbor facilities, airports, power lines—which are usually the responsibility of government. Private markets alone will not replace the economy's infrastructure.

Government itself constitutes a problem because the incentives it is subject to are frequently inconsistent with prescribed goals of public policy.[15] Government representatives and employees must be concerned with retaining popular support. This concern makes them more responsive to constituents who are more likely to vote or to interest groups who, unlike the general electorate, find it worthwhile (for financial gain or because of strongly held ideological views) to incur the costs of monitoring their behavior. Government employees also have personal ambitions involving higher office or larger and more powerful agencies under their control. All of these tendencies, reinforced and exacerbated by the monopoly position of public agencies, loosen the link between government actions and the broad social welfare.[16]

[14]See Dacy and Kunreuther (1969, pp. 63–70).

[15]See, in particular, the discussion in Weimer and Vining (1989, pp. 101–23).

[16]Weimer and Vining (1989, pp. 95–101) also point out that the democratic voting process itself is flawed as a mechanism for determining the goals of public policy.

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In this section, I will offer a blueprint for combining governmental initiatives and market processes in both disaster preparedness and response. My objective is to define a division of labor between government and the private sector that reflects the comparative advantages of each. Because of the incentive problem and the monopoly power that government invariably wields, my blueprint limits government's role to what the competitive private sector cannot provide. At the same time, I believe the private sector's potential contribution to disaster avoidance and recovery is much greater than commonly supposed. Government, however, is the ultimate guarantor of property rights, which are the *sine qua non* of market activity, and the implementor of any blueprint for disaster containment. Unless government promotes market processes both predisaster and postdisaster, markets will not achieve their potential contribution to disaster mitigation.

Role of Government in a Free Society

Government's economic role in a free society is (a) to define and enforce property rights and the legal framework for economic transactions; (b) to provide for the production of goods and services that the electorate desires but are not produced or consumed in sufficient quantity by the private sector; (c) to take whatever measures are necessary to internalize the external costs (such as environmental damage) and benefits of private transactions; (d) to compensate for information asymmetries, where one party in a transaction may be able to withhold relevant information from other parties; and (e) to offset the reduced output and monopoly prices that result from natural monopoly industries. The (b) category refers to public goods—those, like national defense and scientific research, that can be consumed only jointly, whose use is not excludable, and whose privately determined production or use—for all these reasons—will be less than socially optimal.[17]

None of these five functions, as such, require government production, as opposed, say, to government procurement of public goods or regulation of private natural monopolies. Thus, while the U.S. government produces military services, it buys war materiel from private industries. American power companies are both public (government owned and operated) and private (but government regulated).

The basic economic criterion for whether government should produce or procure is, as set forth by Vining and Weimer (1990), whether

[17]See Weimer and Vining (1989, chap. 3).

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the market for the good or service is contestable (potentially competitive). For if the market is contestable, there is an efficiency loss in replacing private competitive production by public monopoly output. But even as procurer, government may exhibit inefficiencies, as in the frequently alleged overpayment for individual weapons components. Such inefficiencies, however, are likely to be smaller and far more readily correctable than those that result from totally nationalized or local government production. That, at least, seems to be the clear implication of the economically motivated denationalizations that have occurred in Britain and France in the past decade and the privatization of various government functions now sweeping the industrial world (see Poole and Fixler 1987).

Military services are not available in contestable markets because one of their essential attributes, absolute loyalty, cannot be provided by (since it cannot be enforced against) mercenaries who may be bid away by the enemy in the midst of a battle. One can imagine other government functions, such as the ability to repair certain weapons or carry out various tax collection procedures, that are highly specialized and are not readily transferrable to or from the private sector. Government typically will have to provide these services itself and compensate its personnel with the security of civil service status or other benefits.[18]

What about disaster management? Here I think government, which, as always, must play a coordinating role, should, wherever feasible, yield to a potential market role that has been growing steadily over time. I refer to the deregulation of goods and services once thought to have public goods or natural monopoly properties but no longer do and the privatization of many functions carried out by government but which contestable private markets are quite capable of performing. In this last category I include the rise of a small but growing cottage industry of disaster response specialists.

Government Promotion of Disaster-Related Market Activity

To improve the rapidity and flexibility of both disaster anticipation and response, government should, as circumstances permit, undertake the following seven initiatives.

1. Free Up All the Sources of Information, Both Public and Private. Dynes (1983, p. 656) urges that government promptly share all information, including disclosure of its sources, so that the public can make its own assessment of the value of the information. Kunreuther (1987) offers innovative suggestions for phrasing the information so

[18]For a discussion of the issues in this paragraph, see Vining and Weimer (1990).

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as to overcome the public's tendency to ignore the consequences of low probability events. An important recent U.S. initiative is the 1986 Emergency Planning and Community Right-To-Know Act, which requires all users, producers, and shippers of hazardous chemicals to report this activity to state and local emergency planning commissions established by the act and to make the information available to all employees and the public at large.

2. *Remove All Regulations on Insurance Companies That Prevent Them from Setting Performance Standards for Their Clients.* Until recently, for example, all 50 American states prohibited the insurers of medical services from evaluating the performance of individual providers. Insurance companies should be free to assess the quality and quantity of health care and to set safety standards in industry. In a counterproductive intervention after World War II, state legislatures increased employer liability for industrial accidents and simultaneously reduced that of employees. A number of statistical studies have documented a resulting increase in the frequency and severity of such accidents.[19]

A further example of such "moral hazard"—actions that increase the magnitude of disasters they seek to mitigate—is government benefits to property owners located on flood plains, earthquake faults, and other hazardous sites. Government has, for example, often subsidized the insurance premiums on these properties and provided generous benefits, including low-cost construction loans, to those suffering disaster damages.[20] While this subsidy may seem humanitarian, it encourages building in hazardous places by lowering the private cost of doing so. The result is an increase in the social (total) costs of disasters, to which government is a party. Dacy and Kunreuther (1969, pp. 245–53) urge that such subsidies be phased out by making no new grants and retaining them only for existing beneficiaries.

3. *Seek the Services of Private Disaster Responders.* Some, like Frederick Cuny (1983) of Intertect in Dallas, Texas, specialize in natural disasters occurring in third world countries. Others, like Disaster Masters, Inc., of Queens in New York City, respond to individuals and firms experiencing floods, explosions, and other emergencies.[21] Among their specialties is the rescue and restoration of records and documents and other objects of value. James Morentz, of Rockville, Maryland, publishes *Hazard Monthly* and offers a

[19]See Chelius (1977).

[20]See Dacy and Kunreuther (1969, pp. 229–30).

[21]See "A General Trouble-Shooter Whose Business Is Booming" (1981).

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whole range of disaster preparedness and relief services. Others offer specialized medical services, containers for shipping grain, portable bridges, and mechanized devices for removing people from burning buildings.[22]

In principle, one can easily imagine the rise of a worldwide industry of private disaster consultants and managers who can oversee the response to earthquakes, hurricanes, floods, and the like. Although their presence in any specific location for any particular kind of disaster will be infrequent, their ability to travel globally will give them an ongoing involvement in disasters and a growing management expertise unlikely to be matched by any local or national public disaster agency. Such consultant services are surely contestable—there is no apparent natural monopoly here—and relatively straightforward to monitor and assess. Municipal and state governments might be well advised to engage in contractual arrangements with consultants as part of a predisaster insurance program.

4. *Protect the Private Business Sector in Disaster-Stricken Areas from Gifts and Donations of Goods and Services.* In-kind gifts tend, of course, to depress the prices and destroy the markets of still-functioning enterprises. In an ingenious solution to this problem, which simultaneously addressed the needs of the poor, the Jamaican government, following the devastating hurricane of September 1988, sold all donated goods to local retailers and turned the proceeds over to low-income families in the form of stamps expendable on food, building materials, etc.[23] The government acted as the wholesaler of goods received from abroad and allowed domestic firms to buy them at prices they believed they could resell them for (inclusive of their profit)—in other words, at prices ultimately determined jointly by the local consumers. In this way, goods having little or no value to Jamaicans were priced accordingly; those meeting postdisaster needs were purchased by those who placed the highest value on them; and all donated goods were distributed by retailers—the individuals most qualified to do so.

To maximize consumer welfare, the population itself should determine how many of their stamps are allocated to food, clothing, or whatever. That is, the stamps should have the properties of money and indeed not be limited to the sum of foreign donations. They should be supplemented and distributed as the local electorate is able and sees fit. Disaster-stricken communities might want to encourage outside donors to give most of their aid in the form of cash,

[22]See "The Hazard Scene: Making a Business of Disaster" (1985).
[23]See Seaga (1988).

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allowing the local population to determine the precise character and source of the bulk of supplies.

5. *Protect the Private Sector from Arbitrary Property Seizures, Including Looting.* A decision by authorities to expropriate private property can never be made lightly, since the costs of doing so in terms of incentives to future savings and investment can be considerable. If the owner of a warehouse containing desperately needed supplies cannot be reached, common sense humanitarianism could well dictate that the supplies be taken—although not without a plan for eventual compensation.[24]

6. *Remove All Rent Controls on Residential and Commercial Structures in Urban Areas.* Such controls—effectively price ceilings on rental units and almost invariably below market-clearing levels—lead to the familiar deterioration of quality and socially wasteful search activity characteristic of controlled commodities.[25] In the disaster context, rent controls are particularly harmful, inhibiting the rapid market-wide expansion and sorting out of the remaining housing stock that the changed pattern of demand would evoke. A decision not to impose rent controls in San Francisco following the earthquake and devastating fire of 1906 opened the way to rapid reconstruction of the city.[26] On the other hand, a rent-control law, imposed in 1947, left owners of nearly a square mile of real estate in Mexico City no incentive for repairing or retaining the area as low-income housing following the 1985 earthquake.[27] In the circumstances, the Mexican government had no better alternative than to expropriate it, attenuating still further the already emasculated private property right in the area. The government promised compensation to the owners over a 10-year period, but with few details and little credibility (the memory of the financially disastrous nationalization of Mexican banks in 1982 was still fresh).[28]

7. *Avoid Imposing Price Controls of Any Kind in the Disaster Aftermath.* One frequently hears horror stories of "price gouging" following disasters, such as 5-pound bags of ice selling for $10, chain

[24]See Dynes (1970, p. 210).

[25]See Navarro (1984, chap. 2), and "Urban Decay, Regulatory Sprawl" (1985).

[26]See Douty (1977, pp. 134–36).

[27]Frederick Cuny informs me that the rent-control agreement permitted the private owners to demolish the property and convert the land to other uses if its state of repair fell below specified levels. This provision was intended to motivate occupants to maintain the property, but they were clearly unequal to the task following the earthquake. Meanwhile, the owners, deprived of a free-market return on their property for 38 years, clearly had no incentive to make predisaster or postdisaster repairs.

[28]See Frazier (1985).

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saws selling at $600, and plywood at $200 a sheet in Charleston, South Carolina, following Hurricane Hugo in September 1989.[29] These were prices that consumers (of which many in the Charleston area are quite affluent) chose, in the circumstances, to pay on the grounds that the benefits exceeded the costs. Without ice, hundreds of dollars of frozen foods might have thawed and been lost and, if immediate repairs were not made, a damaged home worth $100,000 or more might have been totally ruined. The action of the Charleston City Council in banning all price increases forced the populace to act in accordance with much higher shadow prices. Such shadow prices produce the familiar manifestations of nonprice allocation, such as waiting long hours in line or engaging in costly search. The cost in this context, as pointed out by Laband (1989), is the valuable time and effort that might otherwise be expended on productive reconstruction activity.

The argument that prices must be controlled to keep goods affordable to low-income families, including those hardest hit by the disaster, ignores not only the further reductions of supply that controls induce, but also the jobs that are lost when firms are not permitted to bid freely for remaining resources. Such job losses are likely, of course, to fall predominately on lower-income workers.

Unusual price increases are not likely to prevail beyond the first few days of the disaster aftermath. If they do, they perform the valuable function of signaling to the outside world the enormous gain to be made in breaking through the wreckage with additional—and inevitably—more normally priced supplies. Government can facilitate this process by giving wide publicity to high prices. Suppressing the prices is a form of denial that prolongs the problem and increases the likelihood of centrally determined allocations, with all the delays, mismatches, and de facto higher social costs that denial entails.

Promoting disaster-related market activity in the ways described above will not extinguish government's role in disaster management, but should serve to make that role more effective and to focus it, particularly in the direction of coordination. Government's record as a monopoly producer of goods and services (including disaster anticipation and relief) has rarely been noteworthy for efficiency[30]

[29]See "Hugo Damage Expected to Go Past $3 Billion" (1989), McCarthy (1989), and Laband (1989). Laband's analysis, which we draw on, is particularly incisive. Although high postdisaster prices are occasionally reported, the far more common occurrence is a failure of most prices to rise very much, if at all. See n. 14 above.

[30]The basic difficulty is that, in the absence of competitive alternatives, there is no reliable way to evaluate government's performance or to ensure that the most efficient

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and is generally inefficient as a source of social equity. There are far more direct and less costly ways, notably cash grants, to accomplish both efficiency and equity goals.[31] Meanwhile, societies struck by disasters should try to avoid the allocative mechanism, command and control, that works so poorly in nondisaster circumstances. The modern world has had enough disaster experience now to begin to forge more reliable coping methods that also have a high degree of automaticity, flexibility, responsiveness, and continuity.

The Resiliency of the Market

Aaron Wildavsky (1988, p. 2) refers to the disaster-mitigating characteristic of a market economy as its "resiliency." He traces that quality to the tendency of a decentralized, competitive system to take incremental risks, learn by trial and error, and incorporate the knowledge in production methods and output that yield ever-increasing levels of health and safety. The same market activity that generates safety produces wealth, which acts as a catalyst, enlarging the possible scale of learning that can take place and safety that can result.

Whether or not this is the precise underlying process, a decentralized price-directed economy that enjoys a free movement of information, goods, and people is surely better able to anticipate and cope with disasters than one of centralized decisionmaking whose goods and information are produced and transmitted by heavily regulated, protected enterprises. The decentralized market economy will also tend to be wealthier, an attribute that invariably suggests reduced vulnerability to shocks. In the words of Frederick Cuny, "Disasters are a function of underdevelopment. If the earthquake that hit San Salvador hit Southern California, it would rattle the china—not kill 1,500 people."[32] A similar characterization applies to the 1988 earthquake in Soviet Armenia. The high death toll resulted in large part from poorly built structures that collapsed when ground trembling

methods are adopted. One frequently hears references to one or two state emergency planning agencies as being the most accomplished and "efficient." There is, unfortunately, no dynamic competitive process to verify that claim and no built-in mechanism to force other states to emulate the most efficient—assuming that what the latter are doing is indeed both appropriate for, and desired by, other states. See Niskanen (1979).

[31]Grants of $10,000 given by the Federal Emergency Management Agency to those suffering property damage in the San Francisco earthquake of October 1989 appear to have met popular perceptions of equity and efficiency criteria—the latter, in part, by defusing public support for controls. The grants, which were given freely, may, however, have introduced a degree of moral hazard in terms of future earthquake preparedness.

[32]Quoted in Duke (1986).

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turned cinderblock supporting walls into powder. Twenty-five thousand perished in Soviet Armenia; an earthquake of identical magnitude, which struck San Francisco in October 1989, took 67 lives.

Over time, new opportunities to free markets and increase the economy's resiliency and wealth will arise and should be weighed. Among the longer-run possibilities are complete deregulation (or privatization) of telecommunications; deregulation (or privatization) of electric power generation and transmission; the pricing of highways and roads by use of electronic sensors on all vehicles; the removal of all legal barriers to entry in the taxi or jitney-service industries; open bidding by all airlines for airport landing slots; the introduction of competition into the delivery of first-class mail by ending the government's monopoly; removal of all restrictions on branch banking; removal of all barriers to establishment of private, independent "walk-in" emergency medical centers; removal of advertising bans by professional societies and trade associations, bans which tend to limit competition; privatization of other services traditionally carried out by government but, increasingly, producible in contestable markets (such as construction and operation of certain limited access roads, tunnels, and bridges); general road repair and maintenance; sanitation; firefighting; ambulance and emergency rescue operation; water supply and treatment; and, not least, the removal of barriers to the international flow of goods, services, and capital.

Conclusion

We defined a disaster as any loss of resource value over space and time above some threshold level. In this broad definition, any loss of assets, whether resulting from physical destruction or changed valuation, qualifies as a disaster.

The American regulatory response to the oil crises of the 1970s and 1980s illustrates the high costs of postdisaster centralized intervention that contravenes rather than complements market forces. Domestic energy prices held below market-clearing levels reduced the output of energy, raised demand, and exerted upward pressure on world prices. Nonprice allocation diverted resources into costly search activity without increasing aggregate supply. Mandatory allocations failed to yield any demonstrable gains in either efficiency or equity. Macroeconomic measures exacerbated the costs of the disruptions by tightening the money supply more than was justified in the face of the widespread reallocation of resources that the energy shocks had imposed on the economy.

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We argue that, in principle, the economic response to all disasters should entail least-cost supplies that meet consumer preferences. The ability of decentralized markets to equilibrate the response to an oil shock is not necessarily distinguished from, or significantly less than, their ability to restore an economy following a natural disaster or war. The claim that markets cannot equilibrate very large disturbances is belied by the record of postwar recovery in market economies.

Sociologists have documented the fact that people rarely panic following disasters. They also characterize the individual household and community response as the most efficient in the disaster context, citing the inability of centralized authorities to know or implement the optimal response. We argue that markets are a logical complement and enhancement of "emergent human resources" behavior.

The ability of markets to contribute to the spontaneous self-generating response to disasters would be facilitated by the following governmental initiatives; freeing insurance companies to impose performance standards on the insured; eliminating government subsidies and regulations that reward hazardous behavior; providing information and identifying its sources while enabling and encouraging the private sector to do the same; seeking out and employing private-sector disaster specialists and consultants; protecting the private business sector by (a) selling donated postdisaster supplies to local retailers and allocating the revenues to low-income families, (b) avoiding arbitrary property seizures, and (c) acting promptly to prevent looting; avoiding all rent and price controls in the disaster aftermath; and accommodating any general inflation that might result from the disaster-related loss of aggregate output.

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Parasites, Profits, and Politicians: Public Health and Public Choice

Gary M. Anderson

Introduction

In textbook discussions of the problem of public goods, the example of public health—protecting society from infectious disease (both chronic and epidemic)—looms large. While the free market functions efficiently in providing myriad goods and services, one of the purported failings of laissez-faire capitalism is its inability to provide a healthy environment. The provision by government of various public health measures, from mandatory inoculation to sewers to safety regulation of food and drugs, is a favorite textbook illustration of the use of governmental coercion to correct a market failure and improve social welfare. The idea that public health is a public good that can be efficiently provided only by government usually sparks little controversy.

The major evidence of improvement alleged to have resulted from this form of government intervention is the historically well-documented mortality decline in the West, which occurred between the Industrial Revolution and the early part of the 20th century. Death rates from infectious disease fell, infant survival rates rose, and life expectancy began a steady increase. Simultaneously, fertility actually fell, so it is clear that mortality rates were falling because life was somehow becoming safer for the average person and not simply because birthrates were growing faster than death rates.

The common view among historians and advocates of governmentally produced or provided public health is that this mortality decline

Cato Journal, Vol. 9, No. 3 (Winter 1990). Copyright © Cato Institute. All rights reserved.

The author is Professor of Economics at California State University, Northridge. He wishes to thank Pamela J. Brown, David Gay, Dwight Lee, Gary Libecap, Kenneth Ng, and Gordon Tullock for helpful comments and discussion. The usual caveat applies. Research on this project was facilitated by a Liberty Fund Summer Residential Fellowship.

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was in large part the result of efficient efforts of government in mitigating major forms of market failure. Before government began a series of major initiatives in public health, urban areas were grossly unhealthy places where raw sewage ran in the streets, corpses were allowed to decay in the open, garbage accumulated amid immense piles of horse manure, and everything was covered in stinking soot. After about 1875, government began to solve these serious problems by providing sewers, regulating tenements, collecting garbage, restricting pollution, safeguarding the milk supply, and generally protecting the health of urban inhabitants.

There is no denying the dramatic decline in mortality rates that occurred in the late 19th century. Further, massive investments in public health were undertaken, beginning about the same time. However, correlation does not equal causation. Other relevant variables unrelated to public health were changing at the same time, and some of these factors may have played a major role in improving life expectancy. Public health measures may have had little or no net effect on mortality rates. Further, even to the extent that certain forms of public health measures did contribute to the mortality decline, such government activity may have simply *replaced* private market provision of similar public goods that might have been cheaper and more efficient.

Finally, the conventional view of public health is based on an idealized Pigouvian model of selfless bureaucrats and politicians acting to maximize social welfare. While most other areas of governmental activity have been shown to be influenced by the self-interest of economic interest groups and government officials, public health has largely ignored the public choice revolution. Public health, however, is not an area of government activity that is somehow immune to economic interests. Political measures ostensibly designed to improve health have often represented the means by which specific economic pressure groups have achieved "wealth transfers" to their members with the government's assistance.

This paper challenges the conventional view of public health from a public choice perspective. The following section outlines both the orthodox interpretation of the mortality decline and the important variables that may have been more significant than government intervention in producing this shift. The third section considers whether governmental provision or production of various health-related public goods was necessary or efficient and examines historical evidence for private provision of similar services. The fourth section provides an interest-group account of major elements of public health, along with historical evidence that private interest, not the interest of the

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public-at-large, was often the determining factor in policymaking. The final section summarizes and concludes the argument.

Public Health and the Mortality Decline

Prior to about 1850, mortality rates—when standardized for the age structure of the population—fluctuated over the short term but maintained approximately stable mean values over long periods. After about 1850, however, this pattern changed in the West. For example, in England and Wales, the standardized death rate per 1,000 population has declined consistently since 1871–79 (McKeown 1976, p. 52). This decline has occurred throughout Europe, and American mortality rates began a steady decline around the same time (Meeker 1974). As Smith (1983, p. 735) notes, the shift to the current low level of mortality "was evident in most Western societies, including the United States, beginning in the 1880s." This decline resulted primarily from the reduction in fatalities from infectious disease (McKeown 1983). The usual interpretation of the cause of this major change involves the timely intervention by government in the late 19th century. Smith (1983, p. 759) is representative of this view: "Innovations improving the life chances of the entire population, usually summarized under the term public health, were primarily responsible for the secular decline in mortality in Western societies during the half century or so after 1880."[1]

One of the underlying premises behind this claim normally receives little attention but deserves critical scrutiny in its own right. Assume for the sake of argument that governmental provision of public health expenditures can be shown to have played a dominant role in precipitating the decline in mortality. Even so, such activity may have *reduced* the *welfare* of affected individuals.

This result is an example of the basic inconsistency between governmental paternalism and social welfare maximization. Social welfare is identical with the welfare of individuals. Governmental activity that restricts an individual's feasible set of available consumption bundles cannot increase utility, and may even reduce it. Proponents of public health maintain that cities remained dirty and unsanitary places until the late 19th century because markets failed to efficiently internalize externalities. Hence, market failure prevented consumers from obtaining the clean, sanitary environment they would otherwise

[1]Smith (1983, p. 759) also provides an example of a common tendency among demographers and population historians to attach a pro–public health conclusion to a study that itself provides no direct evidence that such government interventions made any difference in mortality rates.

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have been willing to pay for. But there is an alternative explanation for those unpleasant conditions. Cities remained relatively dirty because their inhabitants preferred to allocate available resources to goods other than sanitation. People preferred to give up a lower risk of contracting an infectious disease in exchange for greater quantities of other goods. Understandably, this alternative explanation is not attractive to public health advocates.

An important philosophical issue with economic implications arises in this connection. If individuals are free to spend their available incomes among an array of available goods, and we observe that they "buy" X amount of one particular good, economists conclude that these individuals have allocated their resources in a way that makes them better off. Longevity is simply one kind of good. As such, it tends to be traded off against other kinds of goods. Individuals frequently choose to engage in various activities (e.g., skiing, mountain climbing) that involve increased risk of death, or (equivalently stated) that lower their expected lifespans. How can we claim that mountain climbing represents a mountain climber's effort to maximize his utility, without acknowledging that an individual who selects to live in a relatively high-risk environment is not also maximizing his utility in a rational manner? If the government were to force city dwellers to spend more money on sanitation (e.g., through a tax-financed sewer system) than they were willing to spend, such an action would normally make those individuals worse off rather than better off.[2]

This explanation is in no way intended to deny the economic plausibility of the neoclassical public goods model. It is certainly possible for the rational, self-interested action of individuals to collectively result in a situation characterized by the non-optimal provision of some goods and services from which (for technical reasons) it is difficult to exclude consumers who are not actually contributors. In short, the "free-rider problem" cannot be assumed away. But the very plausibility of the public goods model presents a danger, making it distressingly easy to confuse plausibility ("this might happen") with fact ("things actually happened this way"). Public health is an example of this confusion, apparently because the public goods model seems so plausible as a description of the problem of providing a healthy environment. Many writers, therefore, leap to the unwar-

[2]Naturally, if it can be demonstrated that the governmental action is correcting a failure of the market to efficiently provide a public good, individual taxpayers who were forced to exchange their money for the sewer service could conceivable be net beneficiaries, but this result must be demonstrated; it cannot simply be assumed.

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ranted conclusion that the health of the public is a public goods problem requiring government intervention.

Interestingly, many aspects of public health were strongly opposed by the very groups that were the supposed beneficiaries. Opposition was common among the urban poor, who often perceived public health programs as too expensive, as likely to slow economic growth (and, hence, their own income mobility), and as primarily benefiting the middle and upper-middle classes who desired a cleaner, less smelly urban environment—not for reasons of health but because dirt, disorder, and odors were unpleasant. The poor perceived that they would bear the principal burden of government sanitation measures. As Galishoff (1988, p. 191) concludes:

> Most Americans viewed the filthy skies and waterways in their cities with equanimity. Pollution was seen as a necessary evil, a by-product of economic growth. Indeed, factory smoke and dust-covered workrooms elicited favorable responses, for they were regarded as signs of productivity. Americans believed the increased production and consumption would enable them to enjoy a life of affluence and individual freedom.[3]

Urban dwellers revealed the order of their preferences by their choices in the marketplace; they demonstrated a more intense demand for pecuniary income over the alternative good (clean and sanitary living conditions) at the margin.[4]

Although these considerations are extremely important, there is a critical practical issue that must logically take precedence. The claim that public health played a dominant, or even a major, role in the mortality decline is open to serious question. Several different factors unrelated to public policy may have been more important.

[3]A major effort of the public health movement was to educate the public about the need for citizens to be more concerned about pollution and cleanliness. For example, campaigns in major American cities were aimed at convincing urbanites that they should hate excessive noise. On this peculiar "reformism," see Smilor (1980, pp. 137–47).

[4]In *Wealth of Nations*, Adam Smith argued that compensating differentials in market wage rates efficiently adjusted for the disutility associated with different kinds of labor conditions. The modern literature on hedonic markets has rigorously extended this simple insight. As Williamson (1981) and others have argued, urban dwellers who lived in relatively unsanitary, smelly cities tended to earn significantly higher wages than similar individuals who lived in more pleasant environments. The "Dark, Satanic Mills" were rewarding employees with higher pecuniary incomes and not exploiting them. The vociferous opposition to public health among many of the purported victims of dirt and disorder implies that these people recognized the relevant trade-off, at least implicitly.

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Improvement in Nutrition

One of the most important features of Western economic development was the steady increase in the average quality of human nutrition. Famines became increasing rare, starvation became increasingly unusual, and diet improved.

Two aspects of this development were of primary importance. First, the risk of death from starvation or malnutrition dropped. But perhaps more significantly, an improved nutritional standard by itself led to a marked reduction in the mortality rates associated with most infectious diseases. Improvements in the population's nutritional status appear to have been major factors in reducing mortality rates caused by a variety of life-threatening infectious diseases, including tuberculosis, which was the predominant cause of death in the mid-19th century (McKeown 1976, p. 138). Better nutrition was the result of simple economic development, and governmentally provided public health programs played no significant role in facilitating this development. As real incomes per capita rose, individuals consumed greater quantities of higher quality food.[5]

While the ultimate cause of nutrition-related improvements in health was economic development, the proximate causes may often have been extremely mundane. In her study of mortality in London since 1750, Matossian (1985, p. 197) finds that the most rapid improvement in health occurred between 1795 and 1839, and may have been the side effect of increased potato consumption. She writes:

> It is possible that increasing potato consumption and decreasing rye consumption contributed to this rapid improvement in health. Rye is prone to infection by a fungus, *Claviceps purpurea,* which produces toxic alkaloids than can cause convulsions. Tuberculosis is an immune-deficiency disease, and the presence of mycotoxins in grain may be part of its etiology. Increased reliance on potatoes as a staple starch could therefore reduce mortality from both convulsions and tuberculosis.

Public health programs may actually have played an important role in *retarding* the improvement of nutritional standards, particularly

[5]In economic history, seemingly trivial changes can sometimes be shown to have had profound effects. One such factor was the rise in potato consumption. In addition to the high caloric content of potatoes per pound, they provide a good source of most important minerals, as well as vitamins B_1, B_2, and C. The general use of the potato was a major contributor to the decline in scurvy (caused by vitamin C deficiency), a common ailment throughout history (Salaman 1985, pp. 122–23). The rapid growth in potato consumption by the poor in the 19th century may have substantially lowered mortality rates (Salaman, p. 613).

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among the poor. For example, one of the major forms of public health reform in the United States was milk regulation. Contaminated milk was alleged to greatly increase the risk of infection among children, and a variety of measures were enacted in many municipalities. Impurities (i.e., the use of various preservative agents, as well as the practice of skimming the cream and diluting raw milk with water) were regulated, adversely affecting the supply of milk by driving smaller dairies out of the market. Milk regulation had the unambiguous effect of raising the price of milk to consumers, in some areas by a large percentage. Even if some of these early (prepasteurization)[6] regulations decreased the number of deaths by reducing contamination, the reduction in supply tended to increase deaths among children by reducing nutrition (to which milk was a major contributor).[7] Regulations that increased the price of milk, regardless of their intended consequences, may have had a negative effect on the health of children.

Decline of Infanticide

One of the more grisly facts of demographic history is that prior to the 20th century, infanticide was a major form of "family planning" in the West. Killing infants, either by exposure to the elements or by suffocation, was the only effective means of controlling family size other than sexual abstinence before the 19th century. McKeown (1976) and other demographers have pointed out that the incredibly high infant mortality rates before about 1900 were almost certainly biased upward by deaths that represented the intentional murder of babies and young children as a means of post-birth control. For

[6]Pasteurization is a process whereby milk is heated to kill bacteria and retard fermentation. This process was used in New York City by a philanthropist named Strauss as early as 1892, and milk so treated was distributed at cost to indigent children. Pasteurization dramatically reduced the risk of infection from drinking milk. However, public health authorities did not generally accept the validity of the process until about 1910. Previous to this period, pasteurization was actually *forbidden* by many public health boards, although it was sometimes used surreptitiously (and obviously, voluntarily) by milk dealers in large metropolitan areas. There is no clear evidence that prepasteurization milk regulation made any particular difference in the safety of milk. (See Galishoff 1976, pp. 87–93.)

[7]"Pure food" regulation in general tended to restrict the supply, and increase the price, of nutrition to consumers. The poor were those most likely to suffer actual malnutrition and, hence, increased risk of illness and other health problems as a result. This problem was actually a major concern of Harvey W. Wiley, one of the leaders of the pure food movement in the United States in the late 19th century. He repeatedly maintained that the intent behind the pure food legislation was simply to eliminate mislabeling of products and not to ensure absolute purity. The poor, he said, had to have cheap food, and he declared that "it is not for me to tell my neighbor what he shall eat" (quoted in Kolko 1963, p. 108).

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obvious reasons, precise quantitative information about the extent of infanticide is almost completely unavailable.[8]

One of the major, but less-recognized, gains from economic development is the decline in the use of post-birth control. This decline appears to have directly resulted from several different factors, each related to the progress of economic growth.

The most important factor was probably the greater availability of safe contraception over the course of the 19th century, which provided a birth control alternative to post-birth control.[9] Various effective contraceptive techniques began to become available during the 19th century in America.[10] U.S. survey data suggest that contraception became increasingly used during the late 19th to early 20th centuries.[11] Thus, the relative price of other methods of family planning fell, which contributed to the decline of infanticide.

Another consequence of the greater availability of birth control was the increase in the average health and, hence, in the chance of survival of infants who were at risk of death from other causes. At the margin, the births prevented by contraception would have tended to include children who would have represented relatively high mortality risks. This tendency would have been because birth control was likely to be practiced primarily by parents who would otherwise have produced undernourished or neglected children, *ceteris paribus* (i.e., assuming that infanticide and contraception were not substitutes). Thus, the increasing use of birth control should have resulted in some decline in the mortality rate among children actually born, even if no other significant changes had occurred.

[8]Until modern times, proving that an infant's death was the result of such practices by its parents was virtually impossible. Such murders were usually not what we today think of as child abuse, but cold-blooded efforts at "family planning."

[9]Another, more problematical, influence may have been a change in institutional arrangements for unwanted children. After about 1700, foundling hospitals—institutions that were designed to accept unwanted children—began to appear in both Europe and America and grew rapidly in size and number in the 19th century. Although mortality rates in those places were very high, net mortality was possibly reduced by providing parents of unwanted children an option other than infanticide (see Boswell 1988).

[10]Postcoital vaginal douching using syringes, one of the first relatively safe and effective forms of contraception, began to be advocated by doctors in the United States in the 1830s and 1840s. The use of vulcanized rubber cervical caps and diaphragms, which provided a dramatic improvement in effectiveness over the previously available, more primitive devices, began in the 1870s and 1880s (David and Sanderson 1986, p. 327).

[11]David and Sanderson (1986, p. 324) report that among married, upper-middle-class, American women the percentage of those not using contraception fell from 12.5 percent in 1892, to 5.9 percent in 1913, to 2.4 percent in 1935.

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Antisepsis

Historians do not debate how important medicine was as a factor in increasing the average lifespan, but whether (or how much) pre–20th-century medicine actually *increased* mortality rates. The main problem with medicine before the 20th century was that the germ theory of disease was not generally accepted. People understood that certain diseases tended to be infectious and were spread from the sick to the healthy, but the exact mechanism of such contagion was a mystery. Not until after the 1890s was the role of germs and other microorganisms generally appreciated among doctors.

The lack of understanding the disease mechanism negatively affected mortality rates because of the failure to recognize the importance of antisepsis. Sterilizing instruments, wearing masks and rubber gloves, maintaining strict standards of cleanliness during surgery, and observing other standard measures designed to reduce the risk of postoperative infections were not practiced.[12] The lack of antisepsis had a simple and gruesome result: Most patients died following surgery, even if they survived the crude techniques of the surgeon.[13]

Some modern doctors maintain that medical practice in the United States did not begin to have a positive effect on the survival rate of patients until after 1920.[14] However, after about 1850, the role of germs in spreading infection began to be appreciated; after about 1870, antiseptic procedures became increasingly widespread and mortality rates fell to some extent simply because doctors were causing the deaths of fewer "patients."

Other Influences on Mortality Rates

A variety of additional influences tended to reduce the apparent mortality rate in both the United States and Britain after 1850. While each separate factor probably had only a minor impact, taken together these factors probably made a significant contribution.

[12]Only cauterization (usually involving the use of a white-hot iron to close a wound) was commonly used, although exactly why such an extreme postoperative ritual improved survival rates of patients was unclear to doctors.

[13]About 70 percent of all soldiers receiving battle wounds (even relatively minor wounds) during the Civil War died shortly thereafter (Steiner 1968, p. 8). In 1874, the senior surgeon to the University College Hospital in London concluded that mortality following all forms of amputation (one of the most common surgical procedures) was between 35 and 50 percent and that, following certain forms of amputation, mortality was as high as 90 percent (McKeown 1976, p. 148).

[14]For example, see Szasz (1979). McKeown and Brown (1955, pp. 124–26) note British hospitals made mortality rates worse until the mid-19th century.

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Exposure to cold increases the risk to individuals from contagious disease. In the 19th century, the population of both the United States and most of Europe was concentrated in latitudes that experienced severe cold during the winter.[15] Falling real prices for coal, gas, and electricity resulted in a rise in the average indoor temperature during winter. Before 1850, most homes and apartments lacked windows, but rising incomes and falling prices for glass led to the almost-universal use of windows in city dwellings by 1900.[16] Thus the rise of indoor temperatures—a consequence of increasing wealth, not government intervention—led to some reduction in mortality.

Other factors might have had independent influences on the decline in mortality rates. National armies in Europe and America tended to be relatively small after about 1870, and wars during 1870–1914 were minor and infrequent; military deaths were consequently a smaller contributor to mortality in percentage terms.[17] A major public policy concern today is controlling pollution from the operation of automobiles. However, the introduction of the automobile in the late 19th century directly led to the outright elimination of one of the most worrisome urban pollution problems that had afflicted cities for centuries—horse manure.[18] Such dung stank terribly, but more importantly it attracted swarms of flies that might carry away any of 30 different diseases, including dysentery and typhoid (Galishoff 1988, p. 131). By providing efficient substitutes for horse transportation, Henry Ford may have been an unsung hero of the fight for urban sanitation.

The intention here is not to suggest that governmental interventions termed public health had no effect on reducing mortality rates,

[15]Before the Civil War, most housing lacked central heating. Furnaces began to rapidly replace stoves as winter indoor heating devices after 1870 in the United States.

[16]Another source of indoor heating that became increasingly important in the late-19th century involved something that may seem odd: indoor gas (and later electric) lights. Lamps were relatively inefficient light producers; therefore much of their energy was released in the form of heat. This technical inefficiency provided a significant additional source of indoor heating. The incandescent gaslight was actually invented to exploit this advantage. See Schivelbusch (1988, pp. 45–52; esp. p. 48).

[17]This factor implied a fall in war casualties as a contributor to mortality, but perhaps even more importantly, a fall in deaths caused by encampment. Most deaths of soldiers resulted from infectious disease contracted off the battlefield, principally in camp. For example, during the Civil War two Union soldiers died of disease for every one who died of wounds in battle. The secular decline in the size of standing armies as a percentage to total population is an interesting phenomenon, but this change was completely unrelated to governmental public health spending or expertise.

[18]The average working horse excreted about half a gallon of urine and anywhere from 15 to 22 pounds of manure daily onto city streets. Health officials in Milwaukee calculated that in 1907 the city's 12,500 horses produced 133 tons of offal a day, which was almost entirely deposited in a manner and location determined largely by the convenience of the horse (Galishoff 1988, p. 131).

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or even to offer precise estimates of the relative weights of different available influences on this development. Rather, this account is meant to suggest that a large part of the widely noted mortality decline—perhaps most of it—is directly attributable to the consequences of economic growth and to rising real incomes. Richer people could afford to purchase cleaner water, more and better food, superior transportation, safer medical services, and higher levels of heat in the winter. This income effect was essentially independent of governmental activity claimed to be promoting public health. Free-market-driven economic development led directly to increased life expectancy.

Was Public Health a Public Goods Problem?

One of the shibboleths of public health advocates is that effective private market alternatives that provide municipal sanitation services were unavailable, leaving no recourse to government intervention (cf. Leavitt 1982, pp. 127ff.; Raffel 1984, p. 327; and Rosenkrantz 1972, pp. 6, 23). The apologists for such interventions claim that the major elements in providing urban sanitation and consumer protection represent problems of market failure, and that only the public-spirited efforts of bureaucrats and farsighted politicians were capable of producing efficient sewers, water supplies, food inspections, and the whole panoply of other measures claimed to have played a vital role in the modern mortality decline. Public goods problems in connection with urban sanitation are typically portrayed as obvious and overwhelming.

These arguments usually involve either free riding or economies of scale. For example, in the case of sewage disposal, individual homeowners may prefer to use privy closets or cesspools rather than sewers because poorly specified property rights allow them to shift some costs (e.g., increased risk of infection) onto their neighbors, even though sewers would minimize true social costs. But sewers, as opposed to cesspools and other forms of waste accumulation, require enormous investments of fixed capital and are characterized by falling average costs over a large range. Together these arguments have been commonly used to rationalize governmental monopoly of a huge array of public health measures, from sewers to water supplies to meat inspection.

Indeed, government (in the United States and Britain) quickly monopolized the provision (and usually the production) of most important kinds of infrastructures related to public health (e.g., sewers and waterworks) and aggressively intervened in private markets

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with a variety of licensing and regulatory measures after about 1875. Certain important kinds of public goods rapidly became synonymous in practice with governmentally produced goods. But in most cases, efficient private production of technically similar goods appears to have been feasible; such production was frequently absent only because it had been legislated or regulated out of existence.

The disposal of human wastes provides an interesting example. For most of the 19th century in most American cities, the primary means of disposing of human wastes was the privy closet system. Family privy closets would collect the wastes, which were periodically collected by private collection services for a fee. Wastes so collected were often sold to farms in the vicinity and were recycled in a manner consistent with the ecological concerns of modern environmentalists. This system had problems, however, and proved increasingly unsatisfactory as population density in cities grew.

In the last quarter of the 19th century, sewers began to gradually replace the privy closet system in cities. It is common for defenders of municipal monopolies to argue that a capital-intensive technology for waste disposal like a sewer system involves huge economies of scale and represents a close approximation of a natural monopoly. However plausible such arguments, the fact is that at first private sewer companies were common and appear to have successfully competed in the marketplace with no particularly serious problems. Gradually, municipal authorities asserted a monopoly in providing sewer services, and the private provision of sewer services consequently declined.[19]

Sewers represented one of the very most important contributions of public health in the United States between 1880 and 1920. Huge sums of tax dollars were spent to provide urban sewer systems, and the potential returns in the form of tangible reductions in mortality should have been relatively high for this form of investment. Certainly, contemporary sanitary engineers made very extravagant claims for such gains.

Unfortunately, the municipal monopoly on providing waste disposal seems to have had definitely mixed results in terms of mortality rates. The main difficulty appears to have been the sanitary engi-

[19]In some municipalities, however, private sewer companies were not actually excluded but were increasingly regulated. For example, in 1885 most of Newark's sewer system was privately operated, much of it by land companies through large tracts of land they were developing for sale. After 1893, the city government began an extensive program of building municipal sewers, but even so in 1910 about 12 percent of the sewer-mileage in Newark was privately owned and maintained (Galishoff 1976, pp. 130–31).

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neers' failure to understand, or perhaps their lack of an effective incentive to control, the negative externalities they imposed on other urban areas downstream. Most major American cities were located on rivers or bays, and sewage collected was almost universally released into such bodies of water totally untreated. This disposal technique had two important results: Inhabitants of the disposing city who lived near the outflow points were placed at greater risk of sewage-born disease, and inhabitants of areas downstream (or who were nearby, along the same coastline) were similarly exposed to a steady flow of raw sewage. Naturally, this technique was a dubious sanitary improvement. Tarr, McCurley, and Yosie (1980, pp. 66–67) show that there was an *inverse* correlation for 15 cities with populations of more than 30,000 located along streams and lakes during 1880–1905; for some cities (e.g., Richmond and Nashville), mortality rates jumped drastically following the rapid expansion of government sewer systems. This problem was not addressed in a significant way until the widespread introduction of sewer treatment and filtration, which occurred only after 1910.

Municipal monopoly water supply was also a major area of public health reform. Before the Civil War, supplying water in most American cities had been the province of private entrepreneurs and private well-drilling companies. This private provision was widely criticized for allegedly producing poor-quality water, although the criteria for quality typically involved attributes like clarity and taste, which were unrelated to the presence or absence of disease-carrying organisms. Gradually, municipalities excluded private water companies by law, or regulated private suppliers out of existence while taking various actions intended to "protect their water supplies." Most of these measures had little effect on the safety of water supplies, although sometimes they may have made matters worse.[20] Philadelphia was a leader in protecting its water supply, but the annual rate of death from typhoid (the major waterborne disease) never fell below 35 per 100,000 population and, in 1906, actually rose to more than 80 per 100,000. This experience was common among American cities during the same period. The problem was that the various water treatment

[20]After the Civil War, municipalities commonly delivered water to their citizens through lead pipes, which led to severe problems with lead poisoning. Previous methods of water provision used by private suppliers (who typically delivered water to customers in barrels), or the use of private wells, had rarely caused lead poisoning, although the sanitary reformers complained about the purportedly poor quality of the water delivered to consumers (Blake 1956, pp. 254–55).

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methods (e.g., filtration) had virtually no effect on the bacteria content of the water.[21]

Although a water supply would seem to be a real-world example of a natural monopoly, the supposed economies of scale were not a major argument used by proponents of municipal monopolization of the water services. By the 1840s in many American cities, private companies began to deliver water to their customers through pipes, generally using the same sort of technology that governments used later. But private enterprise was claimed to be unsatisfactory mainly because it was purported to be inequitable. Private water companies were criticized because they were run as businesses and not charities. According to Blake (1956, p.77), private companies refused to supply "all needs" for water in cities but instead laid their pipes in the districts that "promised the highest returns." Moreover, private companies gave priority to their "private customers" and "failed to provide water for important civic purposes." In other words, private companies did not bundle wealth-transfers with their supply of water delivery.

The fact that the private market provided many important sanitary services does not, of course, show that such private provision was optimal. In the presence of significant externalities, such private sewage disposal, water supply, and other sanitation services may have been undersupplied. But the possibility of nonoptimal levels of provision does not constitute evidence for such a condition. The existing evidence shows only that individual urbanites were, in general, unwilling to voluntarily pay for the quantity of certain sanitation services that various professional sanitary engineers and other interested parties felt were adequate. What is commonly described as a market failure may have simply been a demand failure—consumers preferred to allocate their scarce resources to other goods that they regarded as more valuable.

Public Health from a Public Choice Perspective

Gains from the provision of public goods are independent from the motivations behind that provision. If national defense is a public good, and if political decisions lead to an optimal level of national defense (or at least, a more efficient level than would otherwise have been privately provided), then the social benefits that result from those goods and services would be the same regardless of whether

[21]Not until 1910, when liquid chlorine treatment was introduced, did the situation in Philadelphia and other metropolitan areas improve significantly.

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politicians were acting to selflessly maximize social welfare or were engaging in self-interested rent seeking.

Thus, in the case of public health, the question of the effects of government activity on mortality rates and the problem of why governments behaved in this manner are logically distinct. Even if the social benefits purported to have arisen from public health are dubious, the question remains: Were politicians trying to maximize social welfare, or were they pursuing other ends?

Public health refers to a vast array of government interventions and spending programs. The purpose of this section is to present some important examples in which rent seeking on the part of economic interest groups appears to have been a significant motivating factor behind public health reforms.

Restrictions on Food Quality

The Pure Food and Drug Act, passed by the U.S. Congress in 1906, is widely considered a landmark of public health in America. It is usually represented as an early triumph of progressivism, a great victory in the battle to protect the health of consumers from contaminated and adulterated food products sold by greedy, unscrupulous ("big") business firms. However, the Act was actively promoted by food industry associations that represented these larger firms, and it seems to have been aimed at restricting competition rather than protecting consumers.

By 1899, major segments of the food and dairy industries had joined state and federal officials in National Pure Food and Drug Congresses to draft pure food regulations. Many manufacturers supported the pure food movement "to the extent possible without incurring too much animosity from others in the trade" (Sullivan 1927, p. 101) (i.e., the larger firms quietly supported regulations that would impose differential costs on their smaller competitors).[22] These groups were interested in federal regulation to "protect themselves from more unscrupulous associates"—that is, to restrict entry into their respective industries (Kolko 1963, p. 109). Also, federal legislation was viewed by some as a kind of second-best regulatory solution, which would replace inefficient state-level regulation that impeded inter-

[22]In early 1898, advocates of federal pure food legislation called the First National Pure Food and Drug Congress in Washington, D.C. This body included delegates appointed by state governors, plus representatives of professional drug associations, farmers organizations, and a variety of industry groups that would have been directly regulated under such a law. These industry groups included the Creamery Butter Makers' Association, the Brewers' Association, the Confectioners' Association, the Wholesale Grocers' Association, the Retail Grocers' Association, and others.

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state sales by the larger firms with a more uniform, and predictable, set of federal regulations. Perhaps more importantly, state regulation was a relatively poor cartelizing instrument for the larger food and drug firms, in part because state governments were not always diligent in their policing of illicit (i.e., competitive) behavior. A contemporary U.S. Senate document summarized the testimony of business leaders in favor of the Act:

> The chief objection, especially from the standpoint of the manufacturer, to leaving the matter in the hands of state governments is the lack of uniformity in state laws, which makes necessary different kinds of labels according to the state in which the goods are to be shipped. It is also urged that the state laws are insufficient from lack of appropriations necessary to enforce them, and through the lack of sufficient knowledge and efficiency on the part of the officials charged with their enforcement [quoted in Wood 1985, p. 416].

In a secret 1905 meeting of the Proprietary Medicine Association (PMA), a trade association that included most of the larger U.S. pharmaceutical firms, it was decided that the PMA would lobby for a federal law that would impose restrictions on narcotics and alcohol in patent medicines, as well as increased limits on advertising claims. Such legislation was sought because it would have tended to reduce the ability of smaller firms to compete effectively (Young 1974, pp. 81–82).[23]

The Pure Food and Drug Act restricted the ability of Southern liquor companies to use their low-cost cottonseed oil and rectified whiskey production; hence, the Act restricted their competing with larger Northern liquor manufacturers, as well as with many Kentucky and Tennessee distillers of aged whiskey (Barkan 1985, p. 24; Wood 1985, pp. 422–23).[24] The bourbon distillers sought the requirement that compounded alcohol beverages (produced by the rectifiers) be labeled as "imitation whiskey," which the National Wholesale Liquor Dealers' Association (representing the rectifiers) argued would "spell death" to their businesses (Wood 1985).

California wineries (represented by the California Wine Growers' Association) were devoted advocates of both federal and state regulation in the form of pure food bills. The California growers' favored such laws because they would protect them from their Eastern com-

[23]According to one historian of the Progressive era, "manufacturers and distributors [of food products] hoped that mild regulation would destroy their marginal competition" (Wiebe 1962, p. 43).

[24]The Meat Inspection Act of 1906 (the companion bill to the Pure Food and Drug Act of 1906) also received no opposition from the meat-packing industry (Barkan 1985, p. 25).

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petitors, who would be prevented from bottling "anything that looked and smelled like wine under a California label, a practice that considerably damaged California's out-of-state trade as well as the general reputation of California wines" (quoted in Wood 1985, p. 418).

To eliminate competition from the manufacturers of proprietary remedies, leading firms in the drug industry were also active in promoting the 1906 Act. Among the leading advocates of regulation were the founders of Squibb Inc., Abbott Laboratories, and Lederle Laboratories (Wood 1985, pp. 423–24).[25]

Acceptance of the Act by industry associations and their high-powered lobbyists was perhaps the strongest, albeit indirect, indication of the rent-generating aspect of the legislation. Owners of leading food and beverage firms, including H. J. Heintz and Frederick Pabst, played leading roles in promoting legislation; Pabst "was instrumental in securing the support and lobbying efforts of the United States Brewer's Association" for the 1906 bill (Wood 1985, pp. 420–21). "In a Senate dominated by special interests, the absence of significant opposition [to Pure Food and Drug] legislation by 1906 strongly suggests that those interests supported the legislation" (Barkan 1985, p. 24).

The case of oleomargarine is an interesting example that has been extensively studied.[26] Almost immediately after the product appeared, state legislatures began to enact laws restricting margarine sales.[27] Margarine was represented as unhealthful, contaminated, and prepared under unhygienic conditions.[28] Federal laws were also passed beginning in 1886 that imposed increasingly heavy tax burdens on margarine sales and production. Selective taxes by the states

[25]Manufactures of traditional cream of tartar baking powders sought regulation against the manufacture of less-expensive acid-based baking powders. In Missouri, one large tartar firm (Royal) succeeded in obtaining such a ban from the state legislature in 1899. One newspaper reported that according to the St. Louis Circuit Attorney, "1,000 dollar bills were among the powerful arguments used" in obtaining the legislation (Wood 1985, pp. 425–26).

[26]Invented in 1869 as a substitute for butter, margarine was made from various processed animal fats. Production was first undertaken in the United States in 1874, and the product rapidly gained substantial consumer acceptance. Margarine was considerably cheaper than butter, and it had similar taste and other properties.

[27]In 1877, New York was the first state with a law requiring that butter be clearly distinguished from margarine, and 12 other states quickly enacted similar measures (Stuyvenberg 1969, p. 286).

[28]Much of the early hygiene regulation occurred at the state level. By 1902, 32 states had banned coloring the product (margarine was normally white) to resemble butter, and the phrasing of the statutes conveyed the clear impression that margarine was an unhealthy, low-quality imitation of butter (Stuyvenberg 1969, p. 286).

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also grew until, by 1939, margarine was taxed by more than half the states. Only in 1950 did the Senate finally repeal the discriminatory federal taxes on oleomargarine, and most states followed shortly thereafter (Barkan 1985, pp. 288–90). The reason this case is interesting is because a clearly defined economic interest group—dairy farmers—engaged in quite blatant rent seeking and is generally given primary credit for the enactment and maintenance of these discriminatory restrictions and taxes.[29]

Strangely, although many historians now recognize the self-interested nature of much (if not most) of the campaign for food and drug regulation, few question the conventional wisdom that such regulation somehow served the public interest. For example, in his recent review of the historical literature on government regulation of business, McCraw (1975, p. 182) writes:

> Seldom in American history did the goals of private groups form a perfect identity with those of the rest of society, but seldom a perfect antithesis, either. Within the zones of overlap, private groups plausibly claimed service to society, and "capture" co-existed in fleeting calm with "public interest."

Thus, despite the clear evidence that blatant rent seeking motivated the advocates of food and drug regulation, many historians continue to assume that such laws somehow magically served the best interests of society. For many historians, it seems, government is always innocent and cannot be proven guilty.

Tax-Financed Wealth Transfers

Suburban developers in Boston were active in leading the fight to extend municipal, tax-financed water and sewer lines to their communities. Naturally, if inhabitants of those suburbs then bore the tax burden that resulted (through higher property taxes), the usual public goods arguments for public production might apply, but in Boston (and apparently in many other areas) city taxpayers ended up bearing most of the tax burden (Galishoff 1988, p. 191). For developers, the major advantage of government services over private services was that they could shift the cost of the former onto others.

In his study of New York City, Moehring (1981, pp. 28–37) found fire insurance companies among the major proponents of municipal provision of water supplies. These companies wanted the city to subsidize water supplies in order to reduce the risk of fire—and of

[29]"In speeches and publications, the [dairy] organizations waged a violent campaign over the heads of the consumers for measures to be taken against the margarine threat; and the authorities were willing to listen" (Stuyvenberg 1969, p. 284).

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claims on themselves. Chemical manufacturers, candle and soapmakers, tanners and dyers, and other businesses that used large quantities of water also wanted tax-subsidized cheap water—as long as the tax burden fell elsewhere (see Galishoff 1988, p. 195).[30]

Bureaucratic Imperialism

Much of the reform movement in public health was led by individuals who were professional public health bureaucrats and who sought benefits from the expansion of their responsibility. Of particular importance in the United States was the sanitary engineering lobby, a group of professional public utility engineers who aggressively promoted the "professionalization" of such sanitary activities as street cleaning, garbage removal and disposal, water supply, and sewers.[31] Public bureaucracies gradually replaced private competition in supplying sanitary services, and the job opportunities for public sanitary engineers burgeoned (Melosi 1980, pp. 120–21).

Municipal engineers played an especially important role. According to Schultz and McShane (1978, p. 411), they

> stamped their long-range visions of metropolitan planning on the public consciousness over the last half of the nineteenth century. Their successful demands for political autonomy in solving the physical problems of the cities contributed to . . . government run by skilled professionals. At the heart of physical and political changes . . . stood the work of the municipal engineers.

Also, at the heart of bigger municipal government were more jobs at higher wages for the highly organized municipal engineers. They and many other reformers did very well by doing "good."

Conclusion

Although the history of public health in the United States is complex, a simple conclusion emerges after critical analysis: The claim

[30]Bakers, sugar refiners, and brewers (among other businesses) lobbied hard at City Hall for "sanitation reform." They wanted not only cheap water but "pure" water—water without noticeable impurities, regardless of the bacteria content—again as long as they paid a heavily subsidized price.

There were sometimes also political and bureaucratic incentives to have municipalities deliver water and dispose of waste. Fleischman (1988) shows that the City of Milwaukee first gave itself a legal monopoly over providing water and sewers and then proceeded to use this monopoly to force outlying areas to either accept annexation or be refused water utilities and sewage disposal.

[31]In the 1880 census, 70 percent of cities surveyed provided municipal street cleaning, while in 1914, 90 percent did. Municipal garbage disposal rose from 24 percent in 1880 to more than 50 percent in 1914.

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that public health significantly improved the health of the public (at least before about 1925) is empirically dubious. Not only is the available evidence weak and ambiguous, but there are grounds for skepticism that public health investments and the mortality decline were more than coincidentally related. The period during which dramatic gains in expected lifespan and reduced mortality were occurring was also a period when many other important developments were improving health for reasons unrelated to changes in public sanitation practices. Most of these phenomena were, in turn, directly related to the rising real incomes of individuals, caused in turn by simple economic growth and development. Further, a number of highly touted public health reforms quite possibly increased the number of deaths instead of causing mortality rates to decline as they had from these other phenomena. The net effect of public health may even have been to *reduce* the improvement in the health of the public. One would hope that future research, which does not merely *assume* that public health investments improve health, might resolve this issue. But given the present state of the evidence, the question remains open.

However, many of the public health reforms produced direct benefits for particular, well-defined groups in the form of wealth transfers. Public sewers, water supply monopolies, and food regulation may not have produced a decline in mortality, but they seem to have produced significant rents for certain interest groups. Public health was a major device used by organized interest groups to redistribute wealth to themselves. This paper is designed to outline a research agenda for future study of this complex, but important, problem.

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Rethinking and Living with the Limits of Bank Regulation

James B. Thomson and Walker F. Todd

Introduction

The attention of U.S. taxpayers temporarily was drawn to the problems of federal deposit insurance in mid-January 1989 by the Treasury Department's short-lived proposal to make the costs of federal deposit insurance explicit. The attention-grabbing device was a proposed 25 basis points (0.25 percent) fee for deposit insurance. The rationale for the fee was that depositors increasingly choose to rely on deposit insurance instead of their own assessments of the probability of an institution's failure when deciding where to place their funds and how much to place in a single institution.

The savings and loan (S&L) crisis has taught us that managers of insured institutions also have relied too much on deposit insurance and too little on risk control and on pricing for risk when those managers conduct the lending and investment policies of their institutions. Suppliers of capital to insured institutions (all too few of whom were managers whose own funds were at risk) came to view regulatory controls and supervisory evaluations as adequate substitutes for the direct policy guidance and supervision that owners whose own funds were at risk might be expected to provide in the absence of such official insurance, regulation, and supervision. Finally, the taxpayer, having no obvious reason to disbelieve indus-

Cato Journal, Vol. 9, No. 3 (Winter 1990). Copyright © Cato Institute. All rights reserved.

James B. Thomson is Assistant Vice President and Economist at the Federal Reserve Bank of Cleveland. Walker F. Todd is Assistant General Counsel and Research Officer at the Federal Reserve Bank of Cleveland. The views expressed in this essay are entirely those of the authors and are not necessarily the official views of the Federal Reserve Bank of Cleveland or those of the Board of Governors of the Federal Reserve System. Portions of this essay were presented in a Frank M. Engle Memorial Lecture in Bryn Mawr, Pennsylvania, on May 22, 1989, by W. Lee Hoskins, President of the Federal Reserve Bank of Cleveland.

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try and governmental assurances that all was well, ignored the necessary maintenance of the financial services system until it was too late.

Official estimates in August 1989 placed the cost of the S&L bailout at $92–159 billion over 10 years—more than twice the value of the net worth remaining in the healthy part of the industry. But the true cost is now acknowledged to be considerably higher, and rising. If the S&L industry were an automobile, a rational driver (taxpayer), hearing that the repair cost was more than twice the value of his car, might conclude that it would be more efficient to junk the car and apply the same monies toward the purchase of a new car.

In 1957, banking historian Bray Hammond published a book with the apt title *Banks and Politics in America, from the Revolution to the Civil War*. Once we understand that we are dealing with banks and politics, not cars, we can begin to understand that the repair decisions will not be rational or efficient and that the cost will be only a small obstacle to any solution that we can dream up. We might even charge the repair cost on our credit card by putting it "off budget." In any event, the U.S. taxpayer, having deferred necessary maintenance and repairs, now is being asked to pay an exorbitant price when these services are finally performed.

Besides the subsidies mentioned above, the existing regulatory system imposes taxes on the financial services industry, and, like all taxes, these reduce market-oriented incentives for performance and increase overall inefficiency. Such taxes may be explicit (such as franchise taxes and taxes on property owned but leased to others) or implicit (such as non-interest-bearing reserve requirements). The subsidy elements of the financial services industry, in turn, attract nonbank interlopers to the federal safety net. In the end, banks and S&Ls are little more than a set of regulatory taxes and subsidies—nothing inherently special, after all, to differentiate them from other kinds of firms.

There are problems in the financial services industry that need repair, but as Keynes (1931, pp. 139–40) once put it, just because we have magneto trouble does not mean that "we shall soon be back in a rumbling waggon and that motoring is over." The principal purpose of this essay is to describe how we might go about repairing the magneto and, vowing to see that necessary maintenance will be undertaken, how we can resume our journey in comparative comfort and with a degree of safety that is priced explicitly to reflect the risks that we are consciously willing to bear.

The Regulatory Environment

From the mid-1960s through the early 1980s, the financial services industry became less segmented and more integrated and competi-

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tive. The financial-structure arrangements of the 1930s became increasingly challenged, both at home and abroad, especially after 1960. The continued separation of different types of financial institutions into different markets after 1960 could be viewed as owing more to the government's interference in financial markets, in the form of restrictions on the activities of different types of financial institutions, than to natural market developments.

In particular, under the financial structure arrangements of the 1930s, banks, bank holding companies, and thrift institutions were relegated to offering the public a narrow range of financial services in markets protected from the entry of nondepository institutions. In return for the exclusion of banks from their turf, financial services companies that engaged in insurance or securities underwriting were prohibited from accepting retail deposits and were denied direct access to the Federal Reserve's payments mechanism.

Advances in communications and computer technology have, however, increased the volume, geographic scope, and efficiency of financial markets. Those advances also have fostered the development of new, comparatively unregulated services such as money market mutual funds, which are substitutes for traditional banking services. Technological innovations, coupled with the inflationary pressures of the 1970s and early 1980s, have eroded—and in some instances completely broken down—the regulatory barriers among banks, thrifts, and other providers of financial services.

Today, nonbanks compete with banks in markets once exclusively the domain of banks. For example, banks compete with the financing subsidiaries of General Motors and Ford in the market for car loans, with General Electric and Prudential in the commercial loan market, and with Merrill Lynch and Sears in deposit-gathering markets. With the increasing globalization of financial markets, U.S. banks face competition from foreign banks in both the international and domestic markets. Increased competition from both foreign banks and nonbank providers of financial services has reduced domestic banks' and thrifts' shares of the financial services market.

Clearly, as financial markets have become more integrated and competitive, the distinction between depository institutions and other financial institutions is now more closely related to the set of regulatory taxes and subsidies faced by and available to banks and thrifts than to the special nature of their products. In other words, it is the restrictions on organizational form, the locations of the institutions, and what businesses they can engage in, coupled with access to the federal deposit insurance guarantees, the Federal Reserve's

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discount window, and the Federal Reserve's payments mechanism, that make depository institutions special.

This latter-day system of regulatory taxes and subsidies has not kept pace with the changes in financial markets. Regulatory changes in reaction to developments in the marketplace have been made in a piecemeal fashion, usually with the purpose of either validating market innovations or reregulating areas where market forces have made existing regulations obsolete. Just as the market has become adept at reducing or eliminating regulatory taxes, it has become equally adept at increasing the size of the subsidy inherent in programs like fixed-rate federal deposit insurance or access to subsidized discount-window credit, sometimes on less than completely sound collateral.

Federal deposit insurance was adopted in 1933 and began operations in 1934 to prevent a recurrence of systemwide bank runs by small depositors. By guaranteeing the transaction and savings balances of *small* depositors (originally limited to $2,500), deposit insurance removed the incentives for those individuals to participate in runs and, thereby, increased the near-term stability of the financial system, particularly for its smaller unit-bank components. Unfortunately, the way federal deposit insurance is priced and the way it has been administered since World War II have created governmental subsidization of the risks undertaken by insured banks and thrifts. These subsidies, in turn, led to perverse incentives for risk taking by insured institutions and ultimately destabilized the financial system. Misguided policies of regulatory forbearance in the late 1970s and in the 1980s further served to increase both the size and the ultimate taxpayer cost of subsidies.

The recent trend toward more-integrated financial markets and less-specialized institutions is not necessarily a bad one. On the contrary, increased competition among providers of financial services increases their efficiency and reduces the public's cost of financial intermediation. In theory, consumers benefit from better financial services at a lower cost. If we ignore the cost of subsidy elements, society as a whole benefits from competition of financial services because fewer resources are used up in providing those services.

The current regulatory structure needs to be updated to account for the market-driven changes that have occurred. Explicit recognition of perverse incentives is required along with a revamping of the existing system of regulatory taxes and subsidies. Increased emphasis should be placed on market discipline and regulatory oversight in the form of stronger and more effective supervision for insured banks

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and thrifts; less emphasis should be placed on pure "thou shalt" or "thou shalt not" regulation. Of course, to make a reformed system work effectively and in an unsubsidized manner, we need a complete overhaul of federal deposit insurance.

The structural weakness in our financial system is well documented. At the beginning of 1989, one-third of this nation's thrift institutions were either insolvent or on the brink of failing (Barth and Bradley 1989). Another third of the industry needed to raise new capital soon to remain viable. Although the picture is brighter for the banking industry, banks have failed in record numbers during this decade; only in 1988 did the annual number of official S&L failures begin to surpass the annual number of official bank failures in the 1980s. Banks that failed or needed federal assistance to remain open in the 1980s included large banking organizations like Continental Illinois of Chicago, First Republicbank of Dallas, First City Bancorp of Houston, and, most recently, MCorp of Dallas. Furthermore, there are indications of continued weakness in the banking industry. The FDIC's problem-bank list still contains roughly 10 percent of all banks, and the cost of resolving bank failures has averaged as much as 33 cents per dollar of failed bank assets (Bovenzi and Murton 1988). Despite the progress made during the past few years in reducing the exposure of the U.S. banking industry to loans to less-developed countries, these credits continue to be a difficult point of exposure for several of our largest banking institutions (Todd 1988a, 1989).

Much of the blame for the current problems in the banking and thrift industries can be placed on our outdated regulatory structure. For example, regulations that encouraged thrifts to finance portfolios of long-term, fixed-rate mortgages with short-term savings deposits made the thrift industry extremely vulnerable to the secularly rising interest rates in the late 1970s and early 1980s. This defect laid the foundation for the current thrift crisis, as thrifts weakened by interest-rate disintermediation in the 1970s gambled for recovery, and all too often lost, in the deregulated environment of the 1980s. On the whole, experience would suggest that such a regulatory structure provided progressively less-effective supervision and regulation and required increased levels of protection or subsidy for the thrift industry.[1]

Similar examples can be found in banking. For instance, our outdated regulatory system played a role in the banking crisis in the energy and farm belts. Branching laws, which tend to cause restriction of the geographic diversification of banks' loan portfolios, can

[1]For an agency-theoretic discussion of these points, see Kane (1989a).

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make banks extremely susceptible to regional economic downturns. This lack of diversification was especially true in regions like the Southwest, where one or two industries dominated the economy.

These unintended effects of outdated regulations were compounded by the presence of fixed-rate deposit insurance and the politicization of the regulatory process. The willingness of the FDIC and FSLIC to routinely guarantee the deposits of statutorily uninsured depositors and other uninsured claimants when banks and thrifts fail has removed depositors as a source of market discipline on banks and thrifts (Caliguire and Thomson 1987). Political interests have placed numerous roadblocks in the way of those regulators who were courageous enough to try to deal with the problem forcefully in recent years. Rather than deal with problems when they arose, those interests directed political energy at cosmetic efforts to cover up and push each crisis into the future. Policymakers must have hoped that, by buying time to deal with various crises, the ultimate taxpayer cost of, or political accountability for, resolving them would be smaller or more diffused (Kane 1989a).

The combination of an outdated regulatory system, fixed-rate deposit insurance, and politically motivated regulatory forbearance programs has cost the American taxpayer dearly. In terms of economic costs, the financial system is less efficient than it could be. Many bankers and thrift executives are exhausting scarce financial resources in circumventing outdated regulations.

Fixed-rate deposit insurance and regulatory forbearance policies decrease the efficiency of the economy in two ways. First, they protect inefficient firms at the expense of efficient firms and the public. Second, by subsidizing risk, they result in an overinvestment in risky assets for the economy as a whole. For example, by some congressional estimates, Texas will receive a net capital inflow of $31 billion over 30 years from the current S&L rescue plan, essentially the accounting entry that squares the balance sheet for the thrift industry's overinvestment in Texas real estate during the 1980s. For the average citizen, such inefficiencies mean paying higher prices for an inferior product (such as deposits backed by unoccupied Texas real estate).

The fiscal cost of maintaining the status quo has increased dramatically in recent years. Pauley (1989) estimated that resolving the thrift crisis will cost more than $124 billion on a present-value basis.[2]

[2]Pauley's $124 billion estimate includes $50 billion for prior case resolutions and $74 billion for restructuring insolvent thrifts. The $124 billion estimate does not include financing costs for $81 billion ($150 billion) if the spending is financed over 10 (30) years at current market interest rates.

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The Shadow Financial Regulatory Committee issued a statement on December 5, 1988, which estimated that losses not yet recognized on the books of the FDIC, but reasonably probable of occurring, would have exceeded the estimated cumulative premium income and reserves by almost $14 billion at year-end 1988, leaving only a small net positive balance (about $400 million) in the FDIC fund. Another recent analysis estimated that the FDIC's fund should reflect about $10 billion of unrecognized losses, leaving a positive balance of about $4 billion in the fund (Brumbaugh and Litan 1989). Current proposals to resolve the debt crisis of developing countries also could cost the U.S. Treasury another $12 billion through tax losses caused by loan charge-offs, increased quotas for the International Monetary Fund, or governmental assistance for recapitalizing troubled large banks that, in light of the precedent set by the thrift industry's rescue in 1989, is almost certain to be requested in case of a worsened crisis.

Who will pay the $200 billion or more that officials now estimate it will take to clean up the U.S. financial system? Regrettably, the U.S. taxpayer is being asked to foot almost all of the bill, both directly through higher taxes and indirectly through higher borrowing costs, higher transaction account fees, and lower returns on savings. This outcome is the greatest single illustration of the failure of the regulatory structure existing in the financial services industry: Regulation was supposed to prevent such calamitous taxpayer costs from being incurred.

The Inadequacy of Current Reform Measures

Because the current crisis and regulations are inexorably intertwined, two tasks lie before us to avoid aggravating or repeating the current decline of the financial services industry. The first task is the massive cleanup of the financial system; the second is the implementation of comprehensive regulatory and supervisory reforms. Insolvent institutions must be closed or recapitalized before fundamental regulatory reforms can be adopted. However, without meaningful reforms to the deposit insurance mechanism and the regulatory structure, there are strong incentives that would cause the current situation to be repeated, possibly within the next few years (Kane 1989b).

If we have learned anything from the current thrift-industry debacle, it is that deregulation and deposit insurance reform can be applied only to an industry that already is healthy. The increase in deposit insurance coverage from $40,000 to $100,000 in 1980 and the new powers granted to thrifts by the Garn–St. Germain Act of 1982

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and by state legislatures contributed enormously to the losses now facing the U.S. taxpayer. Insolvent thrifts recognized the perverse incentives, then rationally used these new powers (especially liberalized loan-to-value ratios for real estate and direct investments in real estate) to try to gamble their way out of insolvency. Some won their bets and returned to profitability; most, however, did not, and the losses accrued to the FSLIC and, hence, to the U.S. taxpayer. Although many thrifts were quite capable of carrying out increasingly risky deposit-taking and investment strategies using their traditional pre-1980 powers, the experience of the 1980s points out the dangers of expanding risk-taking opportunities for institutions that have little or no private capital.

The events surrounding the March 1985 collapse of the Ohio Deposit Guarantee Fund (ODGF) are a stark warning of the importance of transition when implementing reforms. When institutions are insolvent, changes in deposit insurance coverage, either through reductions in insurance limits or through the failure of the insurance fund (as was the case with the ODGF), cause runs on those (insolvent) institutions. Furthermore, the less time that market participants have to process the information associated with changes in regulations and federal deposit insurance, the greater the probability that runs will occur on solvent institutions, although such runs are infrequent and usually can be stopped once solvency is demonstrated. Besides, the existence of bank runs is not necessarily the problem: The real public policy and legal problem is allowing insolvent banks to remain open and to continue to receive new deposits (Kaufman 1988). Therefore, in addition to dealing with insolvent banks and thrifts now, part of the first task for reform is to provide for a short transitional period in which to adjust to market-oriented reforms.

The importance of transition can be illustrated by thinking of the financial system as a heroin addict and deposit insurance subsidies as heroin. To safely cure our patient of his addiction, we first need to stabilize his condition. In the case of depository institutions, we must stabilize the banking system by closing or recapitalizing insolvent banks and thrifts. Then we need to proceed with a treatment program that allows the patient's body to adjust to functioning without heroin. During this transition period, markets must adjust to functioning without the deposit insurance subsidy. The alternative solution, making the patient withdraw "cold turkey," runs the risk of killing the patient or, in our case, causing the collapse of a large part of our financial system. On the other hand, the "cold turkey" solution is preferable to keeping the patient functioning only by using ever-increasing doses of heroin.

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Some regulators and their political mentors seem to have opted for legalizing the heroin—making deposit insurance available permanently in unlimited amounts—because they say that they do not believe the financial system could stand any withdrawal pains. That choice is wrong, and that approach raises profoundly troubling moral issues, such as whether private bankers should have the right to conduct their fully insured affairs in such a way as to create what amounts to full-faith-and-credit claims on the Treasury, without political accountability.

In August 1989, Congress enacted legislation that largely followed proposals by the Bush administration to deal with the fiscal aspect of the S&L crisis. It is expected that, through higher taxes, the U.S. taxpayer will directly pick up all costs of closing, reorganizing, or recapitalizing the original set of roughly 500 thrifts that are either insolvent or in danger of failing (about $300 billion over 30 years), except for about $40 to $60 billion (the amount estimated to become available from deposit insurance premiums over the years). This latter part of the cost, ostensibly paid by the industry, also will be borne indirectly by consumers through the effects of higher deposit insurance assessments on the pricing of services offered by banks and thrifts.

The first problem with the recently passed Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 is that it fails to commit enough money to resolve the problem fully. Recent statements by FDIC Chairman L. William Seidman indicate that the bailout funding in FIRREA is at least $20 billion less (and perhaps as much as $50 billion to $100 billion less) than what is needed to resolve the funding aspect of the crisis. As with the $10.8 billion of Financing Corporation (FICO) bonds authorized under the Competitive Equality Banking Act of 1987 (about $7 billion have been issued), failure to commit enough resources to solve the S&L problem today only guarantees a much bigger cost for cleaning up the problem in the future. Committing fewer resources than necessary to fully resolve the FSLIC insolvency is analogous to a doctor's removing only part of a cancerous tumor from a patient. It is a sure-fire recipe for a near-term repeat of the crisis. Furthermore, the pressures of the moment in putting together the rescue plan may have caused the needless jettison of alternatives like closing and liquidating all 1,000 or so insolvent and unprofitable thrifts without committing taxpayers' money.

FIRREA does contain reforms to the thrift supervisory and regulatory process, although those reforms are less sweeping now than the ones initially proposed in the Bush administration's plan (upon

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which FIRREA was based). The most significant reform was supposed to be the equalization of capital standards between banks and thrifts. Unfortunately, FIRREA waters down this provision significantly, and thrifts will be allowed to use goodwill (in decreasing amounts) to meet capital requirements until 1995. It remains to be seen whether the gradual phaseout of goodwill as capital by 1995 will survive the lobbying efforts of thrift-industry special interest groups like the U.S. Savings League. Other reforms contained in FIRREA include the separation of the thrift deposit insurance fund from administrative oversight by the Office of Thrift Supervision (formerly the Federal Home Loan Bank Board) and an increase in deposit insurance premiums for banks and thrifts.

The main problem with FIRREA is that it commits huge amounts of money to resolving the S&L crisis without conditioning the availability of that money on fundamental supervisory and regulatory reforms—in particular, reform of the underlying mechanism of federal deposit insurance (Kane 1989b).[3]

Too many banks will continue to be considered too big to let fail; important legal and economic distinctions between insured and uninsured deposits will continue to be ignored; and states with concentrations of troubled S&Ls, such as Texas and California, will not be asked to provide matching funds for the rescue, even though Ohio, Maryland, and Colorado all eventually provided state monies to resolve problems of privately insured S&Ls and industrial banks in their states in recent years.

The federal taxpayer, who will bear the ultimate cost of resolving the FSLIC crisis, has the right to expect that policymakers would institute measures to prevent recurrence of the S&L crisis. Supervisory and regulatory reforms are the appropriate legislative reactions in return for the taxpayer's increase in present-value tax liability. Such reforms would increase the efficiency of the financial system, enabling banks and S&Ls to fail without costing taxpayers a cent for the deposit insurance subsidy, which, in turn, would give the public better financial services at a lower cost.

It might appear at first glance that once a bailout of the S&Ls (as distinguished from putting insolvent and unprofitable thrifts into receivership) was decided upon, it did not matter much who was taxed to pay for it, who received it, whether the bailout funds were raised by taxation or borrowing, whether the borrowing was on budget or off budget, or whether taxpayers or S&L "users" (depositors

[3]For a discussion on the need for reforms to forestall future crises, see Kane (1985, chaps. 5 and 6; 1989a, chap. 6) and Benston et al. (1986).

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and borrowers) should bear the costs. Nevertheless, these issues are significant because of their precedent-setting value and because of what the public's responses to these issues tell us.

For example, in 1987 the average (arithmetic mean) insured deposit account under both FSLIC and FDIC was only about $8,000. In 1988 the average FSLIC-insured account remained at $8,000, while the average FDIC-insured account at closed institutions rose to nearly $12,000. Yet, industry and governmental officials maintain that the financial fabric of Western civilization will rip apart if we fail to pay off deposits as large as $100,000 per account—or even more in those banks deemed by current regulatory standards to be too big to let fail.

The *median* insured amount is even smaller than $8,000 or $12,000, the arithmetic mean being skewed upward somewhat by the small number of $100,000 accounts. Also, the cost of a $124 billion bailout for FSLIC would be slightly in excess of $1,100 per tax return (times about 110 million tax returns). Thus, it requires a remarkable feat of logic, with unusually flexible standards for measuring efficiency or Pareto optimality, for economic policymakers to assert that it is logical, lawful, fair, precedented, efficient, or optimal either to tax the average (mean) taxpayer more than $1,000 at present value or to borrow more than $1,000 at present value for that taxpayer's account, in order to make what amounts to a transfer payment to all holders of insured deposit accounts in excess of $8,000 and to uninsured claimants.

As for precedents, there are none of even remotely comparable magnitude in U.S. history. Recent federal bailouts (Lockheed, New York City, Chrysler, and Continental Illinois) involved amounts ranging from $3 to $80 per tax return, and only the Continental rescue (another deposit insurance–related bailout) involved more than $20 per tax return. In other words, the current S&L bailout is so extraordinarily in a class by itself—a truly world-class white elephant—that there is no rational way to explain it. Yet, it appears that the bailout (as opposed to the harsher alternatives) is considered to make eminent good sense in congressional and lobbying circles in Washington, D.C. On the other hand, the S&L bailout might just be a graphic illustration of the ultimate costs of a politics-as-usual approach to bank supervision and regulation.

Alternative Blueprints for Reform

It is possible to approach deposit insurance and regulatory reform proposals like the choices on a Chinese restaurant's menu (one from

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option A, one from option B, etc.). Political compromises regarding banking structure often resemble choices made from such a menu. Nevertheless, policy choices that are put together in this fashion usually lack intellectual rigor and usually are not very robust in real-world, marketplace competition. It would be preferable to consider the general patterns of the competing options so that future reforms could be built consistently, according to the blueprints for reform that were chosen earlier. The current congressional (and some of the regulatory agencies') plans for reform have certain commendable aspects but are more a hodgepodge of competing and irreconcilable issues than an embodiment of consistent principles.

Three options that are presented below (two polar approaches and one compromise approach) may be considered as yardsticks against which to measure any proposal for beginning to limit the taxpayer's risks while nudging the currently regulated part of the financial services industry in the direction of becoming able to compete, without subsidy, with nonbank financial companies and foreign banks. The benefits of a free-market approach to banking powers, along with the principal yardsticks by which each of the three alternatives should be measured, are efficiency gains and protection of the public purse. The selection of which financial services the providers would offer should be determined increasingly by the markets and decreasingly by the regulators. The three alternatives presented here are (1) reregulation; (2) a free-market approach to banking; and (3) increased supervision, greater market discipline, and limited insurance.

Reregulation

One alternative that seemed increasingly likely for several months but currently seems to be receding somewhat is more regulation of the financial services industry. In a strict sense, reregulation precludes any new powers for regulated financial institutions. Others would argue that new powers are necessary and that stricter regulations can offset the risks to the federal safety net. In a limited and heavily regulated manner, federal regulators already either have approved or have requested public comment on new activities for banks, bank holding companies, and thrifts. The most controversial proposed powers involve expanded deposit-taking, lending, and investment powers. Often, it is proposed that those powers be combined with entirely new or comparatively uncommon activities like insurance and reinsurance brokerage and underwriting, operation of travel agencies and resort hotels, distribution and underwriting of corporate debt and equity securities, direct investments in real estate, and management and leasing of real property.

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In principle, reregulation could be used to protect the federal safety net from risks arising from the new activities. This could be done by increased and risk-sensitive capital adequacy requirements, detailed regulatory safeguards, increased frequency and intensity of supervisory inspections, more mandatory filing of regulatory reports, and requirements for strict enforcement of corporate separateness, often called "firewalls" in the regulatory debates (Keehn 1989). The problem with the "strict supervision/regulation" approach is that it greatly diminishes the overall efficiency of the financial services industry. Increased regulatory taxes could shrink the deposits taken by banks, compared with deposits or comparable accounts taken by competing nonbank financial companies, as a percentage of market share. Greater regulatory taxes would increase the regulated industry's demand to expand regulatory subsidies (the deposit insurance component of the safety net) correspondingly. Indeed, some proponents of more regulation would expand deposit insurance coverage and assume that increased taxpayer costs of this subsidy could be reduced by an increasingly aggressive system of bank regulation. Given the existing tendencies to politicize bank regulation, it is difficult to foresee how a sufficiently objective bank regulatory system could be created to control the risks to the public purse, especially given the perverse incentives currently embedded in the federal safety net.

Excessive reliance on regulations tends to discourage new activities that the regulatory authorities supposedly intend banks to undertake. Moreover, reregulation would drive enterpreneurial bankers into evasive behavior designed to circumvent the regulations. In this manner, S. Waite Rawls, vice chairman of Continental Illinois, noted: The proper response to regulatory firewalls is to "hire real good lawyers" to figure out ways around them.[4]

Principal-agent problems associated with increased regulation create incentives for regulators whose banks fail (or would fail but for the federal safety net) to declare that some banks are too big to let fail but should not be required to shrink, even though such banks could not be supervised or regulated properly in their current size or structure. Belatedly recognizing the fundamental unfairness and inefficiency of such treatment of large banks, regulators increasingly have decided to subsidize small banks too, instead of attempting to reduce the big banks' subsidies. This exercise, if prolonged, will prove to be quite costly for taxpayers.

[4]Quoted in Horowitz (1989, p. 6).

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One fundamental objection to the reregulation of the financial services industry is that it might not be consistent with protection of the federal safety net. The ongoing emergence of new technology, new competitors in the industry, increased costs of supervision, and the resulting inefficiency of a highly regulated industry seem to be strong and well-established forces, whose influence will be difficult to offset. Market forces will continue to circumvent new and existing regulations in attempts to maximize the joint value of bank equity and the subsidy inherent in the safety net (Kane 1977).

The overriding reasons for rejecting ongoing reliance on increased regulation as an alternative to reducing or eliminating both the federal safety net and the increased reliance on market forces are the efficiency losses that would emanate from the destruction of competition and from the consequent damage to taxpayers' property rights. Holders of private capital (bank shares or claims on banks) should not be able to put their funds at risk in ways that automatically trigger taxpayer-funded rescues when those ventures go wrong. The range of acceptable, efficiency-promoting expectations regarding federal subsidy of the risky activities of large banks should be from "never" to "almost never"; instead, the range of actual expectations is from "always" to "almost always." Bankers have perverse incentives to increase the risks in their asset portfolios and to circumvent regulations in doing so when they know in advance that regulators can be counted on for taxpayer-funded rescues when risky investments turn sour.

Free-Market Approach

A second option is the total abolition of both regulatory taxes and public subsidies of banking. On its face, this option—favored by students of free banking and open markets—is the most efficient alternative. Let anyone who wants to open a bank do so, but without federal deposit insurance, a central bank discount window, or a government-sponsored payments mechanism that offers intraday (daylight overdraft) credit. If private entities, including insurance companies, clearinghouses, and the like, want to replace the withdrawn federal guarantees, then let them do so, but only at the explicit cost of their users.

Opponents of this approach argue that deposit insurance and a central bank discount window are necessary to ensure the stability of the financial system (Diamond and Dybvig 1983). Regulation, in turn, they argue, is necessary to limit the cost to the taxpayer of providing the financial safety net. Opponents believe that efficiency gains afforded by a free-market environment come at the cost of

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financial stability and that decreased financial stability may result in a reduction in social welfare. To support their position, opponents of free-market banking often point to the banking crises during the 1930s.

The interpretation of events in the 1930s by defenders of the federal safety net is not consistent with historical evidence. The fragmented structure of the U.S. banking system (prohibition of interstate branch banking) then, as today, arose more from the way banks were regulated than from market-driven evolution. This fragmented structure and the Federal Reserve's failure to supply enough aggregate liquidity to financial markets at critical junctures through open-market operations during the 1929–33 era were two primary causes of the banking system's collapse in the 1930s (Friedman and Schwartz 1963). There was no cheap, efficient, safety-net alternative to collapse in the face of the banking system's structural and liquidity problems.

The stability of the financial system may be enhanced by improving the quantity, quality, and timeliness of information available to market participants, or, in other words, by reducing the information costs for participants in financial markets. Lower information costs lessen the possibility that *irrational* bank runs (runs on solvent institutions) would occur. Clearinghouses and other interbank funding markets should be able to allow solvent, though liquidity-constrained, institutions to demonstrate their solvency and end any irrational runs. Reduced information costs also would reduce the probability of rational bank runs (runs on insolvent institutions) because the market could recognize problems in individual institutions sooner and force corrections through a combination of gradual deposit outflows and higher funding costs for such institutions (Kaufman 1988).

In a free-market banking system, clearinghouses may replace central bank discount-window functions altogether—the clearinghouse acts as the ultimate provider of temporary liquidity assistance to individual institutions. Also, the clearinghouse has market-driven incentives to enforce market-value accounting and early closure rules on its members because all clearinghouse members would have to cover the losses arising from claims on insolvent members whose liabilities were honored in the clearings at par (Gorton and Mullineaux 1987). As long as the central bank or monetary authority supplied sufficient legal-tender or credible, lawful-money liquidity to the market in the aggregate, the market should be able to resolve individual institutions' liquidity problems (Todd 1988b). Moreover, the central bank's discount-window function no longer would be necessary to redress regional liquidity imbalances affecting individ-

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ual, solvent institutions: In a nationwide, free-market banking system, there would be no regional liquidity imbalances that did not, in fact, reflect deeper, underlying causes—like solvency problems.

In short, claims by opponents of free-market banking that active, discount-window operations are necessary to prevent liquidity crises in the banking system and that, consequently, a regulatory apparatus is necessary to prevent abuse of subsidized discount-window credit are unfounded either in logic or in historical fact (Todd 1988b). Although neither claim reflects necessity, a great deal of policymakers' *convenience* might be wrapped up in such claims. One suspects that, as was the case with banking regulation reforms of the 1930s, proponents of a more centralized and more heavily regulated financial structure tend to exaggerate (perhaps unknowingly and in completely good faith) both the potential and actual consequences of bank runs or bank closings to justify the regulatory system and subsidies that they advocate, rather than recognize the overall efficiency and public welfare gains of a free-market banking structure.

Individuals should be able to maintain unimpeded access to transaction accounts, even after bank failure, in a free-market banking structure because a greater variety of other institutions either would assume the transaction accounts in clearinghouse-arranged dispositions of insolvent members or would offer new account services (although not necessarily at the same prices) to depositors of the failed institutions. Thus, from the general public's perspective, overall efficiency and public benefits of a free-market banking structure should be maintained at least at the present level and, in fact, should be much greater.

A free-market financial structure would be more stable, in the aggregate, than its critics claim. Market forces would create stabilizing pressures for much earlier resolutions of problem bank cases than is now the case, even though individual problem banks might perceive the system as less stable from their particular perspectives, because their survival as individual institutions would be much less assured than at present.

The government's role in a free-market environment would be to improve the flow of information to the public, such as by conducting examinations and then publishing the findings (Thomson 1989, 1990). Public filings with the Securities and Exchange Commission and analyses by the rating agencies already perform analogous functions for publicly listed nonbank companies. It should be possible, with correct incentives, for bank supervisors to mimic the information retrieval, analysis, and disclosure functions of the SEC with respect to publicly listed companies.

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A free-market banking system would satisfy the dual objectives of maximum efficiency and minimum taxpayer exposure to loss. Such a system would require a supervisory willingness to allow banks, even the biggest ones, which are "special" only in terms of the regulation and subsidies that they receive, to fail. Also, such a system would increase market discipline, especially depositors' discipline. No bank could be too big to let fail.

It is doubtful that a free-market approach to banking would be feasible if it had to be administered by the current "too big to let fail" regulators or if even the tiniest vestiges of the federal safety net were left in place. Therefore, although this approach is the best one in terms of economic theory and historical logic, it does not appear to be politically viable now because of its potential for displacing too many well-placed defenders of the status quo. Nevertheless, this approach should serve as our long-run objective when designing a system that would be politically feasible in the near future.

Increased Supervision, Greater Market Discipline, and Limited Insurance

An alternative that might move us significantly along the road toward market-responsive banking would combine increased supervision and greater market discipline with a decreased role for pure regulation (Hoskins 1989b). A necessary element of this alternative is reduction of the role and amount of federal deposit insurance. After a forward warning date, all new deposits would be segregated from old deposits and insured only at the limit selected pursuant to administrative deliberations. Old deposits would be grandfathered at the $100,000 deposit balance level, and deposits in excess of $100,000 could be handled with receivership insurance or a modified payout plan. Receivers could estimate probable recoveries on the estates of failed banks and make that percentage of recovery available to depositors immediately. There would be no ceiling amount for such receivership insurance, but there essentially would be coinsurance on all deposits for the unrecovered amounts. The FDIC tried briefly to implement such a plan, called "the modified payout" plan, for uninsured depositors in the early 1980s but abandoned it when Continental Illinois failed in 1984.

A reduction in deposit insurance coverage could be effected by regulation—no new statute would be necessary—because the existing statutes authorize deposit insurance up to the maximum prescribed level ($100,000); they do not require that the deposit insurance ceiling be set at that level. For example, new, lower limits could include a general deposit insurance ceiling of $10,000 (e.g., 90

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percent insurance for amounts between $10,000 and $20,000, 80 percent between $20,000 and $30,000, etc., and not more than 50 percent insurance for deposits in excess of $100,000 *per person* in *all* insured banks, not just per insured account).[5] Strictly enforced, lower limits would allow the "too big to let fail" doctrine to have the decent burial it deserves; would provide supervisors with incentives to adopt early closure policies to prevent or limit the effect of bank runs; would encourage increased reliance on strong and effective supervision (inspection, reporting, and public disclosure) instead of regulatory policies that will always be avoided by skilled lawyers and those who employ them; and would return a large measure of market discipline to banking.[6] In any case, federal deposit insurance in excess of $10,000 per account could be viewed properly as a taxpayer subsidy of the insured bank to induce the depositor to hold claims on the bank instead of Treasury bills.[7] Large banks could be brought into the framework of increased supervision and market discipline by requiring them, or their parent holding companies, to issue debt obligations in wholesale amounts that were subordinated to the claims of the central bank, depositors, and deposit insurers.

Another idea worth considering for making large banks more sensitive to market discipline would be to require common voting equity-holders to purchase predetermined amounts of such subordinated

[5]A version of this approach was proposed by the Federal Reserve Bank of Minneapolis in its 1988 *Annual Report*. Under this plan, complete federal deposit insurance would be limited to $10,000 per insured account (still slightly in excess of the average or arithmetic mean insured account), but with federal insurance available for 90 percent of amounts in excess of $10,000 but less than $100,000. This plan bears some resemblance to the original (1933) concept of "interim" federal deposit insurance, which provided for graduated amounts of coinsurance: 100 percent for accounts up to $10,000, 75 percent for accounts between $10,001 and $50,000, and 50 percent for accounts in excess of $50,000. See the Federal Deposit Insurance Act in *Federal Reserve Bulletin* 19 (1933), pp. 385, 388 (Section 12B of the Federal Reserve Act).

[6]Thomson (1987) shows that lower deposit insurance limits, coupled with strict adherence to those limits, would allow the federal deposit insurers to observe, and then to charge, depository institutions the actuarially fair value of their deposit insurance.

[7]Treasury bills (maturing in as few as three months) may be purchased directly over the counter at Federal Reserve Banks in denominations as small as $10,000. Treasury bills are highly liquid investments (the active secondary market makes them almost perfect substitutes for banks' savings accounts and time deposits) and may be used as collateral for borrowings from banks and securities firms in order to raise cash in advance of maturity. Responding to a questioner after a May 1989 speech, W. Lee Hoskins (1989a), president of Federal Reserve Bank of Cleveland, observed:

> I'm not arguing for the total elimination of [deposit] insurance, although I wouldn't mind living in such an environment. But, if we think we need some insurance, then I think we ought to limit the coverage. You, sir, having some mistrust of banks, may decide that Treasury bills are your best investment. It is not as if the American investor does not have a default-free alternative to banks.

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debt, or to post surety bonds in those amounts obtained from nonbank companies. Subordinated debt or surety bonds would act as an additional, equity-like buffer between losses in the asset portfolio and the exposure of the uninsured depositors, the central bank, and deposit insurers (Kane 1987; Benston et al. 1986, chap. 7). Any move toward improved market discipline would require better communication of information to the public regarding the actual condition of banks (e.g., by requiring or, perhaps, merely authorizing banks to release examination reports and supervisory ratings to the public) and also would require greater use of market-value accounting for banks. Currently, only banks' portfolios of trading account securities are marked to market value regularly; in addition, investment account securities and loans could be marked to market at least once per calendar quarter. This approach would enable banks and bank holding companies to engage in a broader range of activities than they now do and certainly would pose no insurmountable obstacle to increased ties between banks and other types of financial intermediaries. Supervision, reporting, and disclosure would provide some measure of protection to the investing public, while market-value accounting, subordinated debt, and limited deposit insurance would reduce taxpayers' costs if one of the deregulated entities failed. Moreover, if some ongoing separation between banking and nonfinancial firms were desired, that separation would remain possible.

The critical intellectual element in analyzing this third alternative is preservation of the principle that insured deposits should not be used to fund assets whose value is not marked to market regularly and should not be held by banks unwilling to disclose their true condition to the public. If the public chooses to place its funds in banks relying on regulation and nondisclosure to retain market position, then the public gradually should be made to understand that its investments in regulated, nondisclosing banks should not be backed by claims on taxpayer funding. Abroad, depositors in Islamic banking systems already are familiar with the principle that depositors share the profits (higher rates of return on deposits) as well as the losses of their banks (Iqbal and Mirakhor 1987), and U.S. depositors were familiar with this principle before 1933.

Our objective currently should be to allow private individuals to make investment decisions and to reap the rewards while insulating the taxpayer from those individuals' losses. Time and advance warning will be necessary to enable us to make this transition successfully. However, the difficulty in changing the status quo to our desired banking structure should not deter us from pursuing this goal. Segregation of old from new deposits after a future date, phasing down the

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insured deposit ceilings, implementing coinsurance, changing to an early closure rule, and adopting market-value accounting standards are all feasible with enough advance warning. Advance warning also would give us time to prepare to close or reorganize all institutions found to be insolvent or capital deficient.

Conclusion

Our current system of regulatory taxes and subsidies is unworkable and has proved to be very costly. The present situation must be resolved—and quickly. Beyond that, fundamental reforms are necessary, and the provision of taxpayer assistance must be linked to these reforms. The criteria for judging the reforms should be increases in the efficiency of the financial system and protection of the public's purse. Market-oriented reforms that reduce the deposit insurance subsidy and that rely primarily on supervision and market discipline, as opposed to regulation, to guide the actions of bank and thrift managements are superior to other types of reform in meeting these criteria.

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In Defense of Henry Simons' Standing as a Classical Liberal

J. Bradford De Long

Introduction

At a 1981 Los Angeles symposium, subsequently published in the *Journal of Law and Economics* as "The Fire of Truth: A Remembrance of Law and Economics at Chicago, 1931–1970" (Kitch 1983), Ronald Coase challenged the standing of early Chicago school member Henry Simons as a classical liberal:

> I would like to raise a question about Henry Simons. . . . [His] *Positive Program for Laissez Faire* [1934] . . . strikes me as a highly interventionist pamphlet. . . . [I]n antitrust, [Simons] wanted to . . . restructure American industry. . . . [I]n regulation . . . he proposed to reform things by nationalization. . . . I would be interested if someone could explain. . . .[1]

Simons' former Chicago pupils, his successors as upholders of classical liberalism in economics, did not rise to his defense. Instead, they responded as follows: First, they acknowledged that Simons was not a pure liberal, but at best a mixed breed. "You can paint him with different colors . . . ," said Harold Demsetz. "It's quite a mixed picture," said George Stigler.

Second, they admitted that Simons *was* an "interventionist," that he did not believe that, in general, economic activity should be organized through free markets. "[H]e was the man who said that

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Cato Journal, Vol. 9, No. 3 (Winter 1990). Copyright © Cato Institute. All rights reserved.

The author is Assistant Professor of Economics at Harvard University and a Faculty Research Fellow at the National Bureau of Economic Research. He wishes to thank Morton Horwitz, David Levine, Stephen Marglin, Mancur Olson, Melvin Reder, George Stigler, Robert Waldmann, and especially Harvey Leibenstein for helpful comments on an earlier draft of this paper.

[1]Kitch (1983), pp. 178–79. Subsequent quotes from this symposium are from the same pages. The issues discussed here are related to the view of the decline in the "populist" strain of Chicago economics presented by Melvin Reder (1982) in his *Journal of Economic Literature* article on the Chicago school.

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the Federal Trade Commission should be the most important agency in government, a phrase that surely should be on no one's tombstone," joked Stigler; "Everything Ronald [Coase] says is right." And Milton Friedman joined in: "I've gone back and reread the *Positive Program* and been astounded. . . . To think that I thought at the time that it was strongly pro-free market in orientation!"

Third, they argued that Simons should be read in historical context. Though he was not a consistent liberal, he was much closer to being one than the others then at Chicago. "[R]elative to the hectic, excited days of the thirties he was leaning [toward classical liberalism]," said Stigler. "By comparison with almost everybody else he was very free market oriented," said Friedman; "Remember . . . in 1934 . . . I would say that close to a majority of the social scientists and students . . . at . . . Chicago were either members of the Communist Party or very close to it . . . Relative to that . . . atmosphere, the [*Positive Program*] was widely interpreted as being, if you want, reactionary."

Aaron Director alone spoke in defense of Simons' credentials as a classical liberal, but he defended Simons by trying to separate Simons' own views from those Simons expressed in the *Positive Program for Laissez Faire*: "One of [Simons'] interests in these interventionist programs was to make . . . private . . . production palatable to his colleagues."

The consensus assessment reached is clear. Henry Simons had some libertarian intuitions, but he also had many "interventionist" failings. His *Positive Program* is a piece in which libertarian and interventionist impulses uneasily coexist. Simons' reputation as a classical liberal is, therefore, based not on a true image of his beliefs but simply on the fact that he was the closest thing to a classical liberal present in the interventionist intellectual climate of the Depression.

This assessment is far from the one prevailing in 1947, when Director wrote the preface to Simons' *Economic Policy for a Free Society*[2] Then Simons was at the center of the nascent Chicago tradition:

> Professor Simons occupied a unique position in American economics. Through his writings and more especially through his teaching at the University of Chicago, he was slowly establishing himself as the head of a "school." Just as Lord Keynes provided a respectable foundation for the adherents of collectivism, so Simons was providing a respectable foundation for the older faith of freedom and equality [Director 1948, p. v].

[2]Director (1948) in Simons (1948). Simons' most famous articles in this collection include his "Political Credo," "Positive Program for Laissez Faire," and "Rules versus Authorities in Monetary Policy."

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The preface leaves no clue that Simons' writings were corrupted by interventionist prejudices:

> With [the *Positive Program*] Simons found his work, which thereafter consisted of an ever more powerful defense of the direct relationship between the "precious measure of political and economic freedom" and the decentralization of power inherent in a free-market system and an elaboration of the program requisite for survival and proper functioning of such a system [Director 1948, p. vi].

This shift in Simons' pupils' assessment of his work between 1947 and today raises two basic questions. First, which assessment is the correct one? Second, why has Chicago's assessment of Simons' underlying economic philosophy changed?

I claim that the early assessment is the more correct one and that Simons was indeed a pure, consistent, and thoughtful classical liberal. The policy prescriptions Coase identifies as "interventionist" are, in fact, derived from sound liberal principles. And they do not indicate any lack of faith in markets or any falling away from a pro-free-market orientation.

From Simons' perspective, the proper application of free-market principles required a proper assessment of the necessary role the government must play in laying the foundations of a free-market economy. No free-market order is possible without the establishment of property rights, of systems for dispute adjudication, and of rules for contract enforcement. Some instrumentality outside the market itself—which we call the state—must lay the foundations of a free-market order. Simons believed that economists should concern themselves with what the rules of the economic game should be and that the choice of appropriate rules was a complex and subtle matter. This strand of analysis has withered since his time. Stigler and Friedman today do not even recognize these concerns as a part of the Chicago tradition when they see it today in Simons' work.

This paper tries to reconstruct the logic of Simons' *Positive Program* and argues that it is—as Simons believed it to be—squarely in the center of the classical liberal tradition.[3] It then speculates on why the new Chicago school regards Simons as more of an interventionist than a classical liberal on many parts of his original *Positive Program for Laissez Faire*. My own view is that Simons does belong to the liberal tradition and should be confronted within that tradition—not dismissed as alien to it.

[3]I place to one side what is probably the most significant difference between Simons' economic philosophy and the economic philosophy of Chicago today. Simons was very much attached to the use of the tax system to level the distribution of income.

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The answer given to Coase should have been that Simons was as committed to classical liberalism as his pupils are today, but that he saw "freedom," "authority," "intervention," and "market" in ways somewhat different from his successor; Simons places elements from real economies into conceptual boxes slightly differently. But the actual answer given was that Simons was not oriented in favor of free markets. This classification of Simons as a "them"—an interventionist—rather than as an "us"—a free-marketeer—reflects what I see as a weakness in the Chicago tradition. Economists should be grappling with the issues of the appropriate constitution for economic life that concerned Simons, not ignoring them.

The Economic Philosophy of Simons' *Positive Program*

In the opening of the *Positive Program for Laissez Faire*, Simons sounds two notes. The first note is that expanding the domain of the market is essential for the preservation of all kinds of liberty:

> [N]one of the precious "freedoms" which our generation has inherited can be extended, or even maintained, apart from an essential freedom of enterprise—apart from a genuine "division of labor" between competitive and political controls. The existence (and preservation) of a competitive situation in private industry makes possible a minimizing of the responsibilities of the sovereign state. It frees the state from the obligation of adjudicating endless, bitter disputes among persons as participants in different industries and among owners of different kinds of productive services. In a word, it makes possible a political policy of laissez faire. [Simons 1948, pp. 41–42.].[4]

Most to be feared, as Simons saw the world in 1934, are the interventionist policies of the left, technocratic wing of the Roosevelt coalition:

> If we dislike extreme inequality of power, it is appropriate to view with especial misgivings the extension of political (and monopoly) control over relative prices and incomes. Either socialization or the mongrel system of "national planning" implies and requires extreme concentration of political power [Simons 1948, p. 52].

The second note is that the United States in 1934 does indeed face a crisis requiring government action:

> The real enemies of liberty in this country are the naive advocates of managed economy or national planning; but with them we agree

[4]References to *Positive Program* (1934) are to the 1948 reprint in Simons' *Economic Policy for a Free Society*.

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> . . . that there is now imperative need for a sound, positive program of economic legislation [Simons 1948, p. 41].

But government action should expand, not contract, the sphere controlled by competitive markets. In Simons' view, the United States in 1934 had been "ruined by banking and monopoly," and the excesses of the New Deal were simply extensions of the policy mistakes of Coolidge and Hoover:

> [O]ne must condemn the Democrats mainly for their wholesale extension of the worst policies of the past. The N.R.A. is merely Mr. Hoover's trust policy and wage policy writ large. The agricultural measures and many other planning proposals are the logical counterpart and the natural extensions of Republican protectionism [Simons 1948, p. 75].

Simons thus rejects Republican, as well as Democratic, policies on the grounds that they have shrunk the scope of competitive markets. He calls instead for policies that will support the expansion of the competitive sphere.

How does Simons reconcile his belief that the market sphere ought to be expanded with his belief that a "positive program" of government action is needed? By arguing that the maintenance of competitive markets requires more than a withdrawal of government from the business of regulating prices and quantities. The growth of exploitation, authority, and monopoly in all spheres must be checked:

> [T]he great enemy of democracy is monopoly, in all its forms . . . corporations, trade associations . . . trade-unions—or, in general, organization and concentration of power in functional classes [Simons 1948, p. 43].[5]

Monopolies by definition engage in exploitation—the exchange of goods and services at other than competitive free-market prices. Monopolies create situations of personal domination and authority. In these situations one's course of action is determined not by one's assessment of the objective constraints and incentives imposed through competitive equilibrium market prices by natural resources and existing technologies, but by another's deliberate manipulation of incentives to induce obedience. For Simons the good society requires freedom from coercion, and coercion can come from either government decree, union persuasion, or private monopoly.

[5]Of all organizations that threatened to establish private monopoly, Simons hated and feared labor unions the most (see Simons 1948, p. 60). Nevertheless, his assessment of unions does contain some hints that unions could play a positive role analogous to that presented in Freeman and Medoff's (1984) discussion of the "voice" face of unionism.

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In Simons' view, the belief that the government should set up markets so that they remain competitive is a completion of the idea of the night watchman state. The night watchman state enforces contracts and guards against explicit theft. A monopolist is also an implicit thief because his possession of market power leads to the exchange of commodities at prices that do not reflect underlying social scarcities.

Preventing the growth of monopoly is hard. In Frank Knight's terms, competition is a school for monopoly because nothing better persuades entrepreneurs and managers of the benefits of monopoly than exposure to competition (Knight 1935). A private market system, especially one with large firms, tends to drift toward monopoly. The preservation of a free-market order requires that thought and effort be put into establishing institutions to help markets be and remain competitive. Simons argues that in the past governments have erred by directly regulating relative prices, and that those governments should have laid the foundation of markets with an eye toward encouraging competition:

> The great errors of economic policy . . . may be defined . . . in terms of excessive political interference with relative prices, and in terms of disastrous neglect of the positive responsibilities of government under a free-enterprise system. Our governments have tinkered interminably with relative prices. . . . On the other hand, they have never . . . tried to maintain . . . competitive conditions in industry [Simons 1948, p. 42].

Thus Simons explicitly draws a distinction between action to "interfere" with markets by setting prices or quantities by administrative fiat—clearly bad—and government action to build the appropriate "foundation" for a market system by providing legal and institutional support for a system of market exchange that encourages competitive outcomes:

> The representation of laissez faire as a merely do-nothing policy is unfortunate and misleading. It is an obvious responsibility of the state under this policy to maintain the kind of legal and institutional framework within which competition can function effectively as an agency of control. The policy, therefore, should be defined positively, as one under which the state seeks to establish and maintain such conditions that it may avoid the necessity of regulating "the heart of the contract"—that is to say, the necessity of regulating relative prices. Thus, the state is charged, under this "division of labor," with heavy responsibilities and large "control" functions: the maintenance of competitive conditions in industry, the control of the currency . . . the definition of the institution of property . . .

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> not to mention the many social welfare activities [Simons 1948, p. 42].

Simons argues that a government committed to *laissez faire* should lay down the rules of the economic game so as to encourage the development of a competitive instead of a monopolistic market economy. Simons then moves into specifics; the rest of the *Positive Program* consists of arguments about what laws and policies are most likely to encourage competitive outcomes.

The Policy Recommendations of Simons' *Positive Program*

This assessment of Simons—that he did indeed base his position on classical liberal principles—is identical with his own self-assessment. Consider his "Political Credo":

> I hope that [my comments] are fragments of one intelligible general position. . . . The underlying position may be characterized as severely libertarian or, in the English-Continental sense, liberal. The intellectual tradition is intended to be that of Adam Smith . . . Marshall . . . and Knight, and of Locke, Hume, Bentham . . . and Hayek. The distinctive feature of this tradition is emphasis upon liberty as both a requisite and means of progress [Simons 1948, p. 1].

Simons saw the central plank of this approach as a distrust of all large concentrations of power:

> A cardinal tenet of libertarians is that no one may be trusted with much power—no leader, no faction, no party, no "class," no majority, no government, no church, no corporation, no trade association, no labor union, no grange, no professional association, no university, no large organization of any kind [Simons 1948, p. 23].

This fear of power generates a love of markets. For markets replace situations of authority, situations where people are clearly under the command of and subject to the personal will of others, with situations of association where people are constrained only by the objective and impersonal workings of competitive equilibrium market prices that reflect social scarcities imposed on society by nature and the limits of technology. "A free society must," Simons thought, "be organized . . . around voluntary, free exchanges of goods and services (Simons 1948, p. 5).

Yet Simons interprets classical liberalism as requiring that great care be taken to prevent the reemergence of "authority" and "exploitation" either in the form of an intrusive state or of private monopoly. The replacement of command by market is not spontaneous. The

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initial allocation of endowments, definition of property rights, and establishment of institutions of exchange must be conducive to competitive equilibrium or else the market system will fail to realize its promise:

> Libertarians would directly regulate or governmentalize only a small group of intractable "natural monopolies," leaving them largely to local bodies, and then seek, by innumerable policy devices, partly direct but mainly indirect, to render competition more and more effective everywhere else [Simons 1948, p. 30].

The conflict between Simons' own self-assessment and Coase's assessment of Simons is generated by Coase's belief that Simons' "policy devices . . . to render competition more . . . effective" are intrusive state interventions in the marketplace. Coase thus lumps Simons with those whom Simons feared most, those who strove to regulate "the heart of the contract"—relative prices—because they did not trust decentralized competitive markets.

But take a closer look at those of Simons' policy recommendations that Coase calls "interventionist": First comes Simons' assessment of utility regulation. The heart of his argument is that

> Public regulation of private monopoly would seem to be, at best, an anomalous arrangement, tolerable only as a temporary expedient. . . . Analysis of the problem, and examination of experience to date, would seem to indicate the wisdom of abandoning the existing scheme of things with respect to the railroads and utilities, rather than extending the system to incude other industries as well. Political control of utility charges is imperative, to be sure, for competition simply cannot function effectively as an agency of control. . . . In general, however, the state should face the necessity of actually taking over, owning, and managing directly, both railroads and the utilities, and all other industries in which it is impossible to maintain effectively competitive conditions. For industries other than the utilities, there still remains a real alternative to socialization, namely, the establishment and preservation of competition as the regulative agency [Simons 1948, p. 51].

Simons believed that government regulation as it had evolved in the United States was a disaster, yet his response was not to deregulate utilities but to nationalize them. As such, it appears that Coase was right. Nevertheless, Simons made his nationalization argument within the context of his broader liberal perspective on the role of government. He thought that a primary function of government in a free society is to maintain competition. Since it was commonly held that competition could not operate effectively in cases of utilities and natural monopolies, Simons held that the second-best solution was not regulatory pricing but outright nationalization. In his view, it is

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not desirable to allow private monopolies (even if natural) to remain uncontrolled, and so their power must be controlled by political democracy—imperfect as that may be.

Simons' fear of private monopoly power and his proposal for the "elimination of private monopoly in all its forms" ([1934] 1948, p. 57) must be viewed within the context of the times. As Herbert Stein (1987, p. 334), in his *New Palgrave* essay on Simons, points out:

> Simons's concern about private monopoly had always been about its interaction with the state. He feared that government would support private monopolies and then have to become more powerful to control the warring monopolies it had created. The 1934 pamphlet was written at the time of Roosevelt's National Recovery Administration, which was promoting the universal cartelization of business under government aegis. But in 1945 all that was past and the political influence of business seemed too small to be a danger.

Simons' second heresy, his desire to break up large corporations, follows the same underlying logic. He begins by describing where the corporate form of organization is and is not useful:

> The corporation is a socially useful device for organizing the ownership and control in operating companies of size sufficient to obtain the real economies of large-scale production under unified management. It should not be made available, however, for financial consolidation of operating enterprises which are (or which, without serious loss of efficiency, might be) essentially independent as to production management. Horizontal combination should be prohibited, and vertical combinations (integration) should be permitted only so far as clearly compatible with real competition. Few of our gigantic corporations can be defended on the ground that their present size is necessary to reasonably full exploitation of production economies [Simons 1948, p. 59].

This claim (that large firms capture no economies of scale in production) is subject to attack, for if large firms do not capture such economies of scale, why do they exist? This is a powerful objection. One possibility is that large firms capture large (although hard to pin down) economies of scale in distribution. Simons agrees that giant firms do owe their existence to economies of scale in marketing and distribution. But he claims these economies of scale are not social economies.

> There are grave productional diseconomies in giant enterprises; but these are compensated by larger artificial, private "economies" which wise public policy may and should cut away. Notable are the "economies" of national advertising and vast sales organizations (a problem of consumer education, consumer-goods standards, and

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> technical information), of differential access to technical knowledge (patent-pooling and research), and differential access to new capital funds (inordinate centralization of securities markets). All these merely private advantages of great, monopolistic size present challenges which can be met. Reasonable access to markets, to technology, and to capital funds, on the part of new and moderate-sized firms, would mean an end of serious enterprise monopoly [Simons 1948, pp. 34–35].

Today many economists might argue that such information-related economies of scale really are social economies—that a decentralized market finds it difficult to rapidly transfer large amounts of complex information, and that large organizations are better at avoiding research and development duplication and at conveying information about product quality through the development of national brands and their associated reputations. A firm that expects a substantial amount of repeat business from a consumer has a large incentive to try to establish a reputation as a quality producer. But Simons would disagree and might argue that the large firm's reputational advantage is due to the government's failure to provide quality inspections and thus to provide the appropriate underpinnings for a competitive market.

Henry Simons versus Oliver Williamson

I believe that Simons' argument is best understood by considering what was to become the Coase theorem. In the absence of "transactions costs" in the broadest possible sense, the distribution of property rights—rights to perform and to prohibit specific concrete actions—is relevant only for the distribution of wealth and not for whether the market outcome will attain the Pareto frontier. The outcome reached will be Pareto optimal by the definition of a transaction cost as something that blocks a mutually beneficial exchange.

A natural step to take from this starting point is to argue that, in a world *with* transaction costs one ought to draw the lines that separate collections of property rights off from other rights into those bundles of powers and entitlements called "commodities" in such a way as to make the resulting equilibrium distribution of productive activity as close as possible to the zero-transaction costs outcome. The legal system ought to naturally bundle together two rights: where the exercise of one spills over to significantly affect the utility of the other, and where the transactions costs required to strike a bargain would be large if the rights were not bundled together. Liability for accidents on any icy sidewalk should be bundled with occupancy of a neighboring single-family house, and not with possibly absentee

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juridical ownership of property; the liability should especially not fall on the contractor who laid the sidewalk.

Simons' argument can be understood as centered around this point. Where spillovers are substantial, but narrow, and transactions costs are high, rights should be bundled together into a single commodity. When spillovers are substantial and extend to an entire industry, the solution is less obvious. Confronted with the choice of either (a) allowing private internalization of externalities through the formation of monopoly, or (b) pulling the externality-generating activities into the public sector, Simons chooses (b). He sees transfer of the activity to the public sector as the only way to constrain individual discretion and monopoly power—even if such a constraint is weak and imperfect.

Simons, in short, can be interpreted as seeing three possible outcomes to the drawing of the lines determining what commodities should be traded on the market and what commodities should be left to the public sector. First, the legal order can help determine the proper private-public commodity mix. It can make liabilities fall on least-cost risk avoiders, tie rights that have spillovers together in the same commodity, and have private provision whenever feasible and public provision elsewhere. Atomistic markets and a few forms of contract will together suffice for an efficient distribution of productive activity.

Second, the arrangement of property rights can be in some sense "wrong." Strategic behavior and transactions costs can generate positive and negative externalities that are not in any decisionmaker's private calculus. The wedges between private cost and social cost create inefficiencies and a possible role for government provision.

Third, the arrangement of property rights can be wrong, but can be partially compensated by private action. Private agencies can expand to incorporate a wide range of spillovers and externalities. Thus, real costs are incorporated into some private decisionmaker's incentive calculus. But the expansion of the organization's size implies that economic agents are no longer atomistic—that they have market power, and this situation creates another wedge between private and social cost.

This third arrangement can be seen as either a success or a failure. On the one hand, externalities have been internalized; on the other hand, market power has been created. Current fashion is to take the emergence of large-scale organizations as a sign that the market is working, that hierarchies are reaching their optimal size (Williamson 1986). Simons' view was, instead, that the emergence of large-scale

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organizations was a sign that the initial distribution of property rights was wrong.

Where Williamson (1986) would celebrate the elimination of internal transactions costs and dismiss as unimportant the creation of market power, Simons would argue that we need not face the choice between accepting externalities and accepting monopoly. Rather, if the initial distribution of property rights had assigned liability efficiently and those productive activities with large and widely dispersed spillovers had been transferred to the public sector, then the inefficiencies that large organizations are designed to work around would never have arisen. Where Williamson would celebrate how large organizations remove potential market failures, Simons would mourn that the inappropriate size of the public sector and the inappropriate distribution of property rights have created these potential market failures in the first place.

An example may be helpful here. Consider the standard Pigovian railroad that sporadically sets fire to the crops alongside its tracks. Let there be one railroad line, which connects the agriculture region to the city it supplies, and 100 family farms. Each family farm suffers an additional $10 worth of fire damage as a result of the introduction of faster trains that reduce the railroad's costs by $600. What do the three possible outcomes look like?

First, the right to farm the land can be bundled as part of a single traded commodity with the right to collect damages caused by fires set by the passing locomotives. In this case the underlying legal order has gotten the property rights "correct": The outcome generated by the market is efficient if the legal system works cheaply, because the costs saved by running faster locomotives do not balance the liability that the railroad bear for fires generated by those faster locomotives.

Second, the corporate charter of the railroad company can have attached to it an immunity against damages arising from the normal operation of the railroad. In this case it is likely that the railroad will run faster trains and that the fields will burn, because assembling a coalition of farmers who will pay more than $600 to the railroad to "purchase" the right to collect fire indemnification will be difficult. The problem is that farmers who do not join the coalition will, nevertheless, gain their share of the benefits of the coalition's action. This case exhibits a classic Pigovian externality: The social costs of faster trains—the $1,000 value of farm production forgone—exceed the private costs to the railroad.

Third, the railroad can threaten to run faster trains, buy up the farmland at a discount, and then operate as a railroad/agribusiness conglomerate that will internalize the fire externality. This approach

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is efficient—but an unintended consequence is the emergence of market power in the urban food market.

Williamson might applaud the third arrangement as an example of the efficiency of a large hierarchy that internalizes an externality. But would it not be better to have gotten the initial distribution of property rights correct and to have settled for the first arrangement? This is Simons' underlying point. He believes that one rarely has to choose between monopoly and externality and that, instead, externalities can be eliminated by operating directly on the order of property rights and the boundary between the public and private sectors.

Simons sees the emergence of stable private oligopoly or monopoly as a sign that property rights are improperly structured. Sometimes his solution is that the government should step in to make information more widely available: by grading and evaluating commodities, by requiring the licensing of patents, or by establishing clearer standards of liability. Sometimes his solution is that governments should act to provide a stable framework within which exchange can take place. In particular, governments should ensure that property rights are drawn clearly to minimize spillovers and to help set expectations about what kinds of bargains are to be made, thereby reducing wasteful information asymmetries.

Toward Laissez Faire

Simons, therefore, regards the emergence of multiplant, multiproduct, multistate manufacturing firms in the United States around 1900 as a sign that markets are not properly set up to maintain competitive conditions. He hoped to correct this situation by breaking up existing oligopolies and, more important, by restructuring markets so that competition could thrive. According to Simons (1948, p. 60): "Some direct dismantling of corporate empires seems indispensable. The main concern of policy, however, should be that of facilitating new enterprise and multiplication of moderate-sized firms."

Simons' ideas on how to facilitate competition are complex. First come measures to get information about product quality out to the consumer.

> Enterprises like Consumers Research, Inc., may represent the beginnings of an almost revolutionary development. We may hope that such undertakings may flourish and that their growth may be promoted through private endowment. . . . Perhaps we shall see the establishment of endowed, nonprofit-making institutions, of unimpeachable disinterestedness, which will offer to manufacturers . . . the use of the institutions' certification . . . in the labeling of approved products. Ultimately, we may see the labeling and classi-

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> fication of the more staple goods on the basis of Bureau of Standards specifications, so that consumers may know (and insist on knowing) which brands of goods meet requirements for government purchase [Simons 1948, p. 73].

Simons (1948, p. 57) also calls for a "limitation upon the squandering of our resources in advertising and selling activities." It is not clear what Simons is aiming at here. He himself agrees that his position must be "left somewhat imprecise," but argues that "the possibility of profitably utilizing resources to manipulate demand is, perhaps, the greatest source of diseconomy under the existing system" (Simons 1948, p. 71). Possibly he means that some widespread advertising expenditures are intended to greatly degrade the quality of information that consumers obtain. Possibly he rejects consumer sovereignty on the grounds that advertising pushes people's market choices away from their "true" interests. Simons also presses for the compulsory licensing of technology. And he argues that the peculiar centralization of American finance in New York has created a socially wasteful large-firm advantage in obtaining access to capital markets.

Conclusion

In retrospect, given the developments in industrial organization and public choice, Simons now appears to have been wrong in believing that (1) government ownership of utilities may be better than government regulation, and (2) large corporations do not reflect genuine economies and should be broken up. This fact, however, is not a sufficient basis for concluding that he was not a consistent classical liberal in terms of his own understanding of the issues of his time. Subsequent developments in theory and evidence are not a basis for concluding that the perceptions of Simons (or Smith) were not consistent or liberal.

Simons clearly opposed the type of detailed intervention in the economy initiated by Hoover and Roosevelt. He believed, maybe incorrectly, that some restructuring of property rights was necessary to avoid this type of intervention, but this does not seem a sufficient basis for labeling him as an interventionist, as that term was then or is now interpreted.

We should not retroactively condemn Simons (among others) as a heretic from the true doctrine of classical liberalism because later evidence suggests that he was empirically wrong. Classical liberalism is a way of thinking about the government and the economy, not a perfect guide to understanding all political and economic phenomena. By this standard, Simons was a consistent classical liberal of his times, even if, in retrospect, he may now appear to have been wrong in his judgment on specific issues.

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Why, then, does Stigler say that Simons' position is an "interventionist" position—analogous to demands for mandatory airbags, for direct effluent limits as opposed to effluent taxes, for direct oil price controls? Why is it not acknowledged that Simons' position is a "restructuring" position—defining property rights and establishing public enforcement mechanisms for contracts, attempting to set up a legal system that meets as closely as possible the requirements that Coase would suggest? In Simons' mind, his policy recommendations would "intervene" in the market only in the sense that police forces, property rights, and contract enforcement "intervene" by providing the framework necessary for competitive markets to function.

There appear to be three possible answers, all of which certainly contribute to some degree but which, even taken together, appear inadequate for a full explanation. First, the Chicago position today appears to be that all markets are contestable—competitive enough, that is, for practical purposes—except for those that the government has closed down. Stigler and Friedman today see the primary danger coming not from large corporations that exploit purely private economies of scale to gain monopoly power but from interest groups that enter a symbiotic relationship with a government that purports to "regulate" them. Stigler's position leads one to be much more hostile toward the idea of government action: Whenever the government does something, it probably acts in the interest of some powerful and monopolistic interest group. Attempting to restructure markets to aid competition is politically impossible. It is, in fact, a miracle that the underlying system of contract and property rights is as favorable to competition as it is: The best we can do is to slow further deterioration.

But this line of thought paints a picture of a 19th-century Eden of laissez faire from which we have been driven by a government that responds to political pressure exerted by organized interests seeking monopoly. But history did not begin with the formation of the ICC. The then-existing order had been created and managed by a democratic government that was as imperfect and as responsive to interests seeking monopoly as government today. How then did it get so close, and how have we remained so close, to the libertarian ideal?

Pursuing this line of thought would lead to the view that there are two levels of government action: (a) There is action directed at establishing the foundations of free markets—specifying forms of property, rules of exchange, endowments, and rules of evidence for dispute resolution. (b) There is government action directed at creating and supporting private monopoly. Clearly, we wish for government to have as high a ratio of activity (a) to activity (b) as possible. Consideration of the concept of government failure could lead to a position like Simons',

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which is that government must be active in laying the foundations of a market economy and that the dangers of government are best provided against by restraining government with a higher constitutional law that commits it to maintaining competition and prohibits it from committing random acts of intervention. Or such a consideration could lead to a position like Stigler's. Both positions come out of the classical liberal tradition. Simons' belief that the proper constitution of economic policy can be an effective check to "government failure" does not seem grounds for revoking his classical liberal credentials.

The second potential explanation is that research during the past 40 years has shown that economies of scale (and scope) in distribution and research are *social* economies. Large firms are thus optimal in the sense of Coase (1937), not inefficient in the sense of Simons.

The third possible explanation is that the underlying conception of liberty to be guarded has changed. Old-style Chicago—Simons, Knight, and Hayek—tended to fear every exercise of authority, every situation where one person told another what to do. Chicago today worries less about the exercise of authority within private organizations. As long as the organization itself is subject, at some point and some level, to the discipline of the market, they are satisfied.

None of these possible explanations seems to justify the answer that Coase received in Los Angeles. The conflict between Chicago then and Chicago today is about what the necessary foundations for a competitive free-market economy are, and not about the desirability of such an economic order. And the existence of such a conflict within the community of libertarians is denied when Simons is labeled an "interventionist."

This failure to recognize that Chicago's conception of the necessary public foundation of a competitive free-market economy has shifted is regrettable, for there is an ambiguity at the heart of economists' conceptions of the state that should be debated and that is thrown into relief by a comparison between Simons then and Stigler now. State action is to be feared: The state is easily corrupted by rent-seeking interest groups. But the establishment of property rights and of contract enforcement procedures fundamental for the existence of a market economy is itself state action of a sort. There are different ways in which property rights could be defined; there are many possible sets of "rules of the game" for a market economy. The government *acts* when we citizens use it to choose one of these sets. If, as Simons argues following a long tradition that includes Frank Knight, Joseph Schumpeter, and Adam Smith, competitive markets are fragile in the sense that they often contain the seeds of their collapse into monopoly, then the particular "foundations" chosen for the market are of prime importance. One

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would hope to find that set of rules of the game most hostile to the development of private monopoly and to the capture of the government by interests that push for publicly supported monopoly. Fear of government action that "interferes" with relative prices thus leads an economist to embrace government action that provides proper "foundations" for the marketplace. This dilemma may be important, but it remains unrecognized if classical liberals who hold positions like Simons' are mislabeled as "interventionists."

Perhaps Simons' work is best understood as Stein (1987, p. 334) described it:

> The response of a free society liberal—or, as he preferred, "libertarian"—to the rise of totalitarianism in Europe, to the worldwide depression and to the attempt in the democracies, including the United States, to cope with the depression in ways that Simons regarded as threats to freedom.

The failure to acknowledge that Simons is—by his own admission, at least—a consistent classical liberal hinders our understanding of what the real answer to Coase's question should have been, and hinders our understanding of the shift in the application of liberal principles that has taken place between Simons' day and our own.

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Neoclassical Economics as a Theory of Politics and Institutions

Anton D. Lowenberg

Introduction

There are essentially two types of social science explanations of politics and institutions. One approach is to focus on the behavior of the rational individual agent and treat macrostates as outcomes of interaction between individual agents. This is the methodology of neoclassical economics. An alternative approach is to start with social structures and historical context, and to view the individual as merely a passive reflection of these. In economics, this "agentless" emphasis on social structure is characteristic of Marxian, radical, and institutionalist theory.

Ultimately, the usefulness of any research program is to be judged on its ability to explain an increasing number of hitherto unexplained phenomena.[1] A "progressive" research program, to borrow the terminology of Lakatos (1978), possesses an expanding empirical content. Theories within a progressive research program are able to explain novel facts or regularities that were previously unexplained. Conversely, a "regressive" research program is one whose theories require continuous ad hoc changes in order to shore up the fundamental axioms upon which they are based. The theories in a regressive research program continually confront empirical refutation, and they must be amended accordingly.

My purpose is to argue that neoclassical economics encompasses a progressive research program, whereas Marxism, institutionalism,

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The author is Associate Professor of Economics at the University of Colorado at Denver.

[1]A research program (or paradigm) is a cluster of theories all of which are based on a common "hard core" set of axioms, assumptions, or beliefs. The notion of a research program in this sense is due to Lakatos's rational reconstruction of the growth of scientific knowledge (Lakatos 1978).

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and other "holistic" methodologies in economics[2] suffer important drawbacks that impede their explanatory power. I use the term "neoclassical" here very broadly; it includes all theories that are based on the economizing behavior of individual value-maximizing agents. This term would embrace standard textbook theories of production and consumption; the property rights and transaction costs approach to industrial organization, law, history, and social institutions; public choice theories of politics and constitutional arrangements; and even Austrian economics.[3] By contrast, nonneoclassical theories are those that posit the primacy of social structure and assign little role to the individual agent. In addition to Marxian economics, nonneoclassical theories include institutionalism—a theory that regards market exchange as a function of underlying power relations in society.[4]

In this paper, I will start by showing that neoclassical rational choice theory has rapidly expanded its empirical content and explanatory power. Recent theoretical developments have brought many aspects of collective and institutional choice explicitly into the domain of economic theory. Therefore, in the next section I will demonstrate that the typical criticisms leveled against neoclassical economics by radical and institutionalist detractors no longer have much validity. Following that section I will examine some of the weaknesses inherent in structuralist and functionalist theories, and then I will show how some practitioners of modern radical economics have attempted to rescue their paradigm by injecting elements of the neoclassical method. This discussion is offered as evidence of the regressiveness of the structuralist research program when compared to the rational individual choice approach.

The Extension of Neoclassical Economic Theory

In addition to the standard price-theoretic analysis of market exchange and production, neoclassical economics now also provides testable theories of institutions and nonmarket interactions. The extension of the scope of economic theory into this area is evidence

[2]See Boland (1982) on the distinction between methodological individualism and methodological holism.

[3]This is not to deny the substantial differences between these various subprograms. As long as they share some crucial hard-core axioms, different paradigms can be viewed as belonging to the same overall research program even if they contain conflicting propositions or theories. On the relationship between subprograms and the larger research program, see Remenyi (1979), Cross (1982), Weintraub (1985), and Heijdra and Lowenberg (1988).

[4]For a good brief summary of the major differences among neoclassical economics, Marxism, and institutionalism, see Medema (1989).

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of the progressivity of the neoclassical research program. It also debunks the claims of Marxians, post-Keynesians, institutionalists, and other nonneoclassical economists that only their respective schools are able to deal adequately with institutions. Orthodox Marxians, for example, have traditionally rejected the methodology of neoclassical economics on the grounds that it is based on an atomistic isolated individual and is, therefore, unable to supply a theory of history, social institutions, collective behavior, or anything else that lies outside the realm of narrow market exchange (Hunt and Schwartz 1972, p. 8).

It is certainly true that the basis of neoclassical economics is methodological individualism. The individual is modeled as an evaluating, choosing, and acting agent (Buchanan 1987, p. 244). Aggregate social phenomena (of both the market and nonmarket variety) are then explained in terms of individual actions and their interrelations (Vanberg 1986, p. 80). Every observed social outcome is treated as an endogenous product of a process of individual choice and exchange, in the context of perceived constraints. The much touted (and thoroughly misunderstood) assumption of "individual rationality" is really quite innocuous. It simply means that individuals strive to make themselves as well off as possible, given their tastes and the resources and knowledge that they possess.[5] This assumption does not imply that the rational actor of neoclassical economics pursues only pecuniary wealth. Anything that is valued by the individual is a legitimate source of utility. Whether something is valued depends on whether individuals reveal by their behavior that they are willing to sacrifice some other object of utility in order to attain more of the "good" in question. This good might be a marketed commodity like apples or oranges, but it could also be a less-tangible form of satisfaction like charitable giving or the propagation of some ideological or religious belief. The minimal assumption required for this economic theory of human behavior is simply that identifiable self-interest (for example, net wealth, social position, fairness, altruism, etc.) motivates the choosing individual. Note that this assumption does not give primacy to the pursuit of narrowly conceived economic interests, nor does it impute any mali-

[5]The method of neoclassical economics is, in fact, a variant of what Karl Popper calls "situation analysis"—individuals' actions are dictated by the logic of a situation in which they find themselves, assuming that they will use only those actions that are most appropriate to their situation. See Hands (1985, p. 84); Boland (1982, p. 32); and Latsis (1976). Langlois (1986, p. 236) points out that the advantage of situational analysis is that it renders unnecessary a detailed psychologistic study of the internal mechanisms of human decisionmaking. A knowledge of the agent's environment (including institutions) serves as a substitute for a detailed knowledge of his or her psychology.

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cious or selfish motives to the individual agent.[6] Furthermore, it obviates the oft-repeated complaint of nonneoclassicals that the rational choice framework cannot explain altruism.[7]

One of the great discoveries of such 18th-century political economists as Mandeville, Hume, Tucker, Ferguson, and Adam Smith is that self-interested individual behavior can have unintended, but nevertheless beneficial, consequences for society. Unrestricted individual exchange will ensure that scarce resources flow to their highest valued uses. This efficient outcome—what Hayek (1976, p. 99) calls "the spontaneous order of the market"—is not, and indeed cannot be, brought about through the design of any person or group. Individuals are driven primarily by their own self-interest, and no single individual or group of individuals can possibly possess enough information to implement the kind of massive coordination that is effected by market prices.[8] This view does not by any means preclude the existence of benevolent motives, but benevolence is scarce (it usually does not extend very far beyond close family and acquaintances). Therefore, a rationally organized society will economize on its use, rather than rely upon it to achieve an efficient allocation of resources.[9]

Apart from market resource allocation, many aggregate social outcomes can be modeled by means of so-called "invisible hand" explanations. Institutions, rules, mores, culture, tradition, and other behavioral regularities are often explained by economists as products of evolutionary-competitive processes.[10] This explanation is what Menger originally referred to as "organic" evolution of social conventions (Schotter 1986, p. 118). In the Mengerian research program, institutions are treated as the explananda of invisible hand theories (Langlois 1986, p. 247). The latter theories characterize institutions and rules as the products of a process involving the separate actions of individuals who do not deliberately intend to bring about the outcomes in question, but whose collective pursuit of individual interests is sufficient to ensure those outcomes (Vanberg 1986, pp. 80–81). This notion of a spontaneous social order emerging as an unintended consequence out of a catallaxy of individual exchanges has been formulated most explicitly by the Austrian school, although its intellectual heritage includes earlier ideas such as Mandeville's

[6]See Buchanan (1987, p. 245).

[7]See, for example, Dearlove (1989, p. 225) for a recent statement of this mistaken view.

[8]See Vanberg (1986, p. 78) and Lavoie (1989, p. 627).

[9]See Coase (1976).

[10]See Gray (1984, pp. 33–34) and Witt (1989).

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"Private Vices, Public Virtues" and Adam Smith's own conception of the invisible hand of the market.[11] Contemporary examples of the invisible hand type of explanations include Douglass North's theory of economic history (1981), the property rights and transaction costs theory of industrial organization (Demsetz 1967 and Williamson 1985), the economic theory of the common law and the family (Posner 1977 and Becker 1976), and the economic theory of constitutions and rules (Brennan and Buchanan 1985). Common to all of these is the axiom that rational individuals will seek to exploit profit opportunities (broadly conceived) whenever they arise, which in turn ensures that welfare enhancing institutional innovations will occur whenever the net benefits are positive. Again, the term "benefit" is to be interpreted to include more than just pecuniary gains.

However, the economic theory of political and social institutions does not treat all institutional forms as spontaneous, socially desirable products of a catallaxy of individual wealth maximization. Within the broad rubric of neoclassical economics there has developed the field of public choice, which provides an economic theory of politics on the basis of the same methodological individualism that underpins other branches of neoclassical economics. Central to public choice theory is the recognition that optimal resource allocation does not always arise spontaneously out of individual optimizing behavior, because of various prisoner dilemma problems associated with the pursuit of collective outcomes. This theory makes it necessary to study the political processes through which individual preferences are translated into social structures. Public choice theory is informed by several converging strands of scholarly inquiry. These strands include most importantly Wicksell and Buchanan's approach to the economics of rule making; Duncan Black's work on collective choice exercized through committees and voting (a work that draws on earlier insights on social choice by the Marquis de Condorcet and Lewis Carroll); Anthony Downs' economic model of political exchange under democracy; Gordon Tullock's analysis of the welfare costs of rent seeking; Stigler and Peltzman's "capture" theory of regulation; and the theory of interest groups, which starts with the political scientists Truman and Bentley, and which is further developed by Olson and more recently formalized by Becker.

While there are important differences that separate some of these schools, there are considerable areas of overlap. For example, Chicago-style political economy generalizes the economic theory of regulation into a theory of politics that has much similarity to the Virginia

[11]See Heijdra, Lowenberg, and Mallick (1988, pp. 298–99).

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school. These variants of public choice theory all share the assumption that individuals are no less self-interested in their capacity as political actors than they are in the economic sphere. This assumption represents a definite movement away from the older tradition in neoclassical economics, which treated the government essentially as a beneficent social engineer.

Some public choice models are voter oriented. According to this approach, political entrepreneurs (politicians) are interested only in gaining or retaining office. They adopt platforms and implement policies that they believe most closely accord with the preferences of the majority of voters. Government policy is viewed as an essentially passive reflection of the desires of the median voter. This theory explains why, in a two-party polity, both parties will tend to position themselves close to the political center at election time.

But as Kuran (1988) points out, the vote-centered theory has several deficiencies. It fails to explain, for example, why the distribution of political influence across discernable groups of voters is disproportionate to their size. It also fails to explain why in most societies—democratic or otherwise—large amounts of resources are devoted to influencing the way people know, think, and want. An alternative public choice approach comprises what Kuran calls "group-centered" theories. According to this perspective, politics can be analyzed as a process of competition among numerous private interests seeking influence over government policy, with the state acting as an impartial broker of wealth transfers between suppliers and demanders (Becker 1983 and Tollison 1989, p. 294).[12] Although the resultant political outcomes seldom embody efficient resource allocations in the usual Pareto sense, they do maximize the influence-weighted sum of utilities of the constituent interest groups.[13] The

[12]A similar distinction between voter- and group-oriented approaches is made somewhat more rigorously by Denzau and Munger (1986). In their model, the voter-based theory is one in which voters are fully informed and the prime concern of legislators is to discover the preferences of their geographical constituencies. The group-based theory, on the other hand, implies that voters are rationally ignorant of everything except the resource expenditures of legislators on their behalf, but, since those resources come from interest group contributions, it follows that interest groups largely control the legislator's actions.

[13]There are, however, significant differences between the Chicago and Virginia versions of the interest group theory of politics. Chicago political economy presents a strictly *positive* theory of politics. According to this approach, competitive lobbying among interest groups will tend to produce efficient outcomes, in the sense that the deadweight costs of government wealth transfers are minimized (although they are still large relative to the transfers they sustain). The existence of government redistribution is taken for granted. The Virginia school, by contrast, focuses attention on the inefficiencies created by special interest group behavior and rent seeking. It is a reformist,

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weight attached to each group depends on its relative efficiency in exerting political influence, which in turn depends on its ability to overcome the incentive for its members to free ride on the pursuit of collectively sought outcomes. Olson, in his classic work (1965) on collective action, shows that selective (or excludable) incentives are necessary to transform a coalition of rational individuals into a "privileged" interest group.

In some variants of this model, politicians and bureaucrats are assumed to have their own goals, which need not coincide with those of their constituents. Politicians, for example, might desire certain public interest policies, which reflect a broad ideological conception of what is good for society as opposed to the special interests of the pressure groups whose lobbying and support brought the politicians into office. There is considerable debate among public choice theorists about whether legislators are constrained always to vote in accordance with what their constituents want, or whether there is scope for them to indulge their own ideological preferences. Stigler, Peltzman, and others of the Chicago school believe that the appearance of ideological voting is, in fact, an illusion, masking underlying economic interests or processes of vote trading (logrolling) that are coincident with the self-interest of constituents (Tollison 1989, p. 294). But logrolling does have the effect of tying together diverse interests in alliances that enable each interest group's preferred policy to be enacted, to the detriment of the median voter's well-being. Bureaucrats, too, might be more interested in maximizing the size or budget of their departments than in serving the interests of either politicians or voters. Thus, some group-centered theories of politics do allow for a considerable degree of slack in the principal-agent relationship between constituents and political entrepreneurs.

Related to the group-centered approach are the notion of rent seeking and the capture theories of economic regulation. Abstracting from the special (and relatively rare) case of decreasing costs, all *permanent* monopoly profits are treated as artifacts of government restrictions on entry.[14] Producer groups will expend resources to persuade or pressure the government into enacting such regulations. Rent-seeking expenditures generate welfare costs for society as a

utilitarian approach, which implicitly compares the existing regulatory system of redistribution with some putative benchmark of efficiency (perfect competition) in which redistribution does not occur (Tollison 1989, p. 295; Gray 1987, p. 44).

[14]Otherwise, economic profits are temporary rewards for enterprise or risk taking, which provide the impetus for economic growth and innovation and are ultimately competed away by entry of new producers or development of new products. See DiLorenzo (1988).

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whole, on top of the standard deadweight costs associated with any deviation from competition. Rent seeking is usually characterized as wasteful because it uses up resources to redistribute the existing social dividend rather than to enlarge it.[15]

Models of interest group competition and rent seeking have much explanatory power. It is evident that a great many interventions of government in the market—such as occupational licensure laws, health and safety regulations, farm subsidy programs, and protectionist tariffs and quotas, to name but a few—create benefits for organized industrial or labor interests who usually lobbied for them in the first place. Almost all of these policies serve to preclude less-organized groups of producers or workers from competing with the beneficiary groups, thereby preserving substantial rents for the beneficiaries. Of course, the number of people who actually benefit from most government regulations is small compared to the numerous consumers who are hurt by higher prices. The regulations are welfare reducing for society, which means that the losers lose more than the winners gain.[16] But this is precisely one of the most powerful predictions of the group-centered theory of politics. Small groups have greater relative political influence than large ones because the benefits sought by small groups are highly concentrated among their members. As such, individual members of small interest groups have an incentive to contribute resources to the pursuit of the group's collective goal (Olson 1965). Even though the welfare costs of special interest regulations are enormous (witness the costs to U.S. consumers of agricultural price supports or the quota on imported sugar), these losses are spread thinly over a vast number of individuals. (It is instructive to note that the most effective pressure in the United States for freer trade policy comes from exporter groups, not consumers.)

Public choice theories of interest groups and rent seeking have one thing in common with Marxian and radical theories. Both explain social outcomes as products of relative group influences. In the case of orthodox Marxism, the state is viewed as an agent of the ruling class and all government policies are treated as functional to the interests of this class. Public choice theory suggests simply that

[15]See Buchanan (1980).

[16]However, it could be argued that some regulations, while affording protection to producer groups from competition, also have positive external effects that outweigh their costs. For example, limiting entry into the liquor retailing business, and thereby raising prices, prevents the sale of liquor to minors because the rents accruing to the holders of liquor licenses provide substantial collateral insuring against malfeasance (Svorny 1987).

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the more influential interests will gain at the expense of the less influential. But the former interests are not always identified with capital nor the latter with labor. As Stigler reportedly observed, if he is a Marxian, he is a better Marxian than Marx (Tollison 1989, p. 296).

However, neither the voter-oriented nor the group-oriented theory, in its simple formulations, represents the last word of neoclassical economics on political and institutional change. Recent work by some economists recognizes that collective action quite often occurs, not as a response of elected politicians to the preferences of the median voter, nor even as the result of organized interest group pressures. The free-rider problem notwithstanding, rational individuals are observed to make anonymous contributions to political causes and even to take to the streets in large crowds without evidence of explicit incitement by organized interests or the presence of selective incentives (witness recent events in Eastern Europe). Clearly, any appreciation for the causes of institutional change requires an understanding of ideology. According to Sartori, ideology is "an important variable in explaining conflict, consensus, and cohesion . . . [and] the decisive variable in explaining mass mobilization and manipulation" (cited in Higgs 1987, p. 45).

There is a growing consensus among neoclassical economists that social change is often ushered in by changes in prevailing beliefs, which are strong enough to overcome the usual proclivity of the rational individual to avoid costly political participation. For Higgs (1987), ideology enables individuals to consume a feeling of solidarity or belonging with other, like-minded, individuals. The degree to which one's self-perceived identity corresponds with the standards of one's chosen reference group is a positive argument in the individual's utility function, and the willingness to trade off material well-being for this nebulous quality helps to explain political action in a large-group context (Higgs 1987, pp. 42–43). North (1981, p. 49) argues that ideology is an economizing device by which individuals interpret their environment, obviating the need for costly information gathering. People occupying different positions in the social division of labor will generally have different experiences of the world and, therefore, different ideologies.[17] But Kuran (1988) shows that ideology itself is endogenous to the process of public discourse. Individuals will find it privately advantageous to espouse an ideology publicly if they believe that the majority of their fellow citizens also

[17]"As the distribution of occupational, ethnic, and other attributes changes because of industrialization, urbanization, or international migration, a society's ideological composition presumably changes, too" (Higgs 1987, p. 53). See also North (1988).

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believe it. Hence, interest groups will often attempt to portray their goals as popular in order to shape the ideological preferences of the majority in their favor.

Criticisms of the Neoclassical Theory of Society

Modern critics of neoclassical theories of politics and institutions focus on two main lines of attack. Some have argued that the expansion of neoclassical economics into the domain of nonmarket behavior is limited by informational and cognitive constraints on individual decisionmaking capabilities. Nicolaides (1988), for example, maintains that the neoclassical rationality hypothesis cannot be applied uniformly to all areas of human choice, because individuals will separate their perceptions of the world into arbitrary segments to make information more manageable. Thus, individuals will use different decision rules for different circumstances. Nicolaides characterizes this problem as "the inherent paradox and inextricable limit to the expansion of neoclassical economics" (p. 324).

To illustrate this purported limit to the expansion of neoclassical theory, Nicolaides offers an example of a neoclassical model of market interaction in which some sellers are Muslims and derive utility from praying at certain times of day, during which they must close shop. He claims that profit maximization is not an appropriate assumption in this case because the Muslim sellers are willing to sacrifice profit for religious observance at a rate of substitution that (he assumes) is invariant to other market prices. However, such preferences can easily be incorporated into the structure of an economic model with fruitful results. An example is Becker's approach to race or sex discrimination in labor markets, in which a nonpecuniary source of satisfaction, which reduces pecuniary wealth, enters the model in the form of a self-imposed tax on the producer (Becker 1976). While it might be supposed that these producers will ultimately be driven out of the market, this outcome does not necessarily occur in the presence of entry barriers (which can be cultural in origin) or if there is not a sufficient number of suppliers unaffected by the religion/discrimination tax.

More generally, the claim that neoclassical economics ignores the problem of information is a specious indictment. Limitations of information and knowledge, far from being alien to neoclassical economists, are central to their analysis. Scarcity of information, like any other resource, is axiomatic to rational individual choice theory and is often incorporated in the formal structure of the models in the same way as other resource constraints. The search for knowledge

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is precisely what drives the entrepreneurial process of discovery. Uncovering new and hitherto unknowable profit opportunities is the role of the entrepreneur, broadly conceived as an agent of either market or nonmarket institutional change. Viewed from a dynamic perspective, many types of competition for profits are simply instruments used by the market process to eliminate imperfections in knowledge that hinder exchange (DiLorenzo 1984, p. 187). In fact, the very existence of temporary monopoly profits and quasi-rents is itself often created by opportunities or incentives to discover new products, techniques, and methods that continually arise in the competitive process (Littlechild 1981, pp. 355–59). Hence, information and knowledge are a vital part of neoclassical analysis, especially in the "process" view of competition.

Another line of attack against the extension of economics into the field of politics comes from institutionalists who object to methodological individualism on the grounds that it ignores the impact of social structure on individual preferences. Thus Dearlove (1989, p. 223) argues that it is important to try to *understand* (as opposed to predict) political developments by interpreting their significance in the kind of larger context that offers meaning to the actors and participants. He accuses the neoclassical perspective of focusing on abstract individuals and their preferences and, therefore, of failing to get to grips with institutional behavior and the workings of concrete political systems (Dearlove 1989, p. 230). According to Dearlove, although public choice theory attempts to explain what rational individuals will do given the pattern of existing norms and institutions, there is no attempt to account for the character of the larger system within which actors behave.

The accusation forwarded by Dearlove, however, is false, especially when we take into account some of the more recent advances in the neoclassical theory of institutions and ideology. The importance of institutions in neoclassical models essentially varies with the purpose of the particular model in question. For some purposes it is adequate to treat institutions as exogenous constraints, part of the "situation" that dictates a certain course of action by maximizing agents. Social institutions, in this context of situational analysis, often serve an information-economizing role. They place constraints on individuals, which restrict the dimensions of their problem situations and thereby reduce the cognitive demands placed on individuals. Alternatively, however, if the purpose of the theorist is to explain the evolution of institutions themselves, this can be accomplished by treating institutions as the explananda of a theory in which rules of human interaction emerge spontaneously out of the separate actions

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of self-interested individuals, without intentional design (Heijdra, Lowenberg, and Mallick 1988). This is an example of the invisible hand type of explanation that I referred to earlier. It is consistent with the Mengerian notion of organic evolution of institutions.

Dearlove further argues (1989, p. 232) that the public choice approach ignores constitutions, except in making normative prescriptions for constitutional reform. But this is also an incorrect statement. The public choice perspective is, in fact, a constitutional perspective, since it emphasizes the rules shaping individual incentives, and the process of cooperation under alternative sets of existing rules (Dorn 1987, p. 284).

Ultimately, however, the success of neoclassical economics as a theory of institutional change must be judged in terms of its explanatory power relative to competing approaches. It is not appropriate to criticize neoclassical economics on the grounds that its assumptions are not realistic or that they are not testable (*assumptions* of a theory are not intended to be tested, only its predictions). Yet this inappropriate criticism is precisely what some nonneoclassical writers do when evaluating neoclassical models. Nicolaides (1988, p. 320), for example, contends that because of imperfections of information, the different choices confronting an individual cannot be evaluated in terms of a single utility function. He also maintains that the neoclassical assertion that rules of behavior are information-saving devices has never been tested empirically (Nicolaides 1988, p. 322). Whether or not these complaints are valid is beside the point. The proof of the pudding is in the ability of neoclassical theory to explain and predict better than its competitors, not in the descriptive realism of its assumptions. I will turn now to examine the competition.

Structuralist and Functionalist Theories of Society

Marxism and institutionalism are structuralist theories. This means that individuals are viewed as products of a social structure within which they live. These theories abstract from the autonomy of the individual agent in favor of the view that individuals are important only in as much as they are the bearers of a particular social structure. As Dearlove (1989, p. 219) points out, structuralist perspectives on politics are problematic because they oversocialize individuals and treat them as passive in the face of grand social changes that come from nowhere and over which individuals have little comprehension and control. There is also a strong element of functionalism in these theories, in the sense that individual actions are treated as somehow determined by the needs of the system as a whole (Dearlove 1989,

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p. 230). All behavioral patterns or institutions have a function that explains their presence.[18] Thus, as Dearlove observes, the structuralist-functionalist approach fails to deal with causes and mechanisms and, in ignoring the microfoundations of social theory, that approach can make only speculative claims about macrostructures and long-term changes.

Marxian and radical economics are prone to a particularly strong form of functionalism that has been labeled "objective teleology," in which a purpose is postulated without a purposive actor.[19] Marxian explanations of society are good examples of objective teleology, in the sense that all endogenous social outcomes are viewed as serving the needs of capitalism or the capitalist class. Institutions exist precisely because they are functional to capitalism. Even those institutions that are clearly antithetical to the interests of capitalists are given a functionalist explanation, as evidenced by Marx's analysis of the (anticapitalist) Bonapartist state in France, which Marx asserts was necessary for the survival of capitalism.[20]

There are two difficulties with functionalist explanations. First, since there are no intentional actors whose actions are instrumental in bringing about observed institutions, it is not clear how those institutions are actually created (Elster 1985, p. 17). John Roemer (1981, p. 9), for example, complains that the standard Marxian theory of capitalist crisis postulates "socialist transformation without a mechanism." Similarly, Jon Elster (1982, p. 460) points out that the functionalist explanations that are pervasive in Marxian theory generally posit a purpose without a purposive actor. He draws a grammatical analogy to a "predicate without a subject." Everything that happens in a capitalist society necessarily corresponds to the needs of capitalism. The same point is made by Michael Taylor (1988, p. 96) who observes that structuralist, functionalist, and other "holistic" theories are typically coarse-grained in the sense that they relate macrostates directly to macrostates without supplying a mechanism to show how the one brings about the other.

It is well understood by neoclassical economists that collective outcomes have attributes of public goods, which means that self-interested individuals will not necessarily contribute to the pursuit of those outcomes even if the individuals all stand to benefit from attaining them. Of course, collective action is undertaken, often suc-

[18]On functionalism, see Langlois (1986, p. 249); Vanberg (1986, p. 83); Elster (1982, p. 454); and Roemer (1981, p. 9).

[19]See Elster (1982).

[20]See Marx and Engels (1979, p. 143), cited in Elster (1982, p. 458).

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cessfully, despite the free-rider problem. But the choice processes that actually serve to transform individual value-maximization into collective goods must be explained or modeled explicitly because these processes are by no means self-evident. For example, how did thousands of capitalists in Bonapartist France get together and establish an "anticapitalist" state so as to obscure from the masses the true configuration of political power?

Public choice theory postulates an intentional actor—the value-maximizing individual—who provides an explanatory link between individual behavior and collective action. Marxism and other structuralist perspectives, by contrast, are based on methodological holism, according to which the prime unit of analysis is not the individual, but the class or group. Methodological individualism, on the other hand, allows economists to address the complexities of political exchange—such phenomena as preference cycling in voting, logrolling in representative democracy, and evolving ideology—which derive from the pursuit of individual self-interest in the political arena. Structuralist approaches contain no comparable mechanism to explain the actual formulation and exertion of class interests.

A second problem with functionalist explanations is that they are inherently untestable and, therefore, fail to fulfill the main positivist standard of scientificity.[21] If the emergence of all social and economic institutions is explained simply by the fact that they are functional to the capitalist mode of production (for example), then their existence can always be accounted for on these grounds alone. As Elster points out, almost any social outcome can be rationalized by arguing that it serves either the interests of the capitalist class or the interests of "capital" (capitalist institutions as a social system), especially when the latter interests are often viewed as separate from (even antagonistic to) capitalist class interests in order to ensure the legitimacy of capitalist hegemony. It is difficult to refute empirically such a claim. Consider, for example, some predictions of Marxian crisis theory: The capitalist system must go through crises because they are necessary to the demise of capitalism, the rate of profit must fall because only in this way can a crisis be precipitated, and the working class must become impoverished because otherwise it could not perform its revolutionary task (Roemer 1981).[22]

[21]See Popper (1965). See also Caldwell (1982) for an excellent treatment of positivism.

[22]On the predictive failures of Marxian economics, see Gordon (1987). He argues that the labor theory of value (which is not really a theory at all, but a definition) yields a series of propositions about the world. When translated into neoclassical terms, these propositions are easily shown to be incorrect. On the flaws inherent in the labor theory of value, see Stigler (1977) and Brooks, Heijdra, and Lowenberg (1990).

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Marxian Emulation of Neoclassical Economics[23]

If imitation is the sincerest form of flattery, then at least some Marxian social theorists have recently provided the strongest possible vindication of neoclassical economics. Efforts by so-called analytical or rational-choice Marxians to emulate the microfoundations of neoclassical value theory and the interest group pluralism of public choice theory testify to the explanatory superiority of the neoclassical approach. These imitative moves by the structuralist school are also evidence of its regressiveness as a research program, in as much as they involve ad hoc changes to the basic research strategy (inconsistent with the underlying axioms) in order to shore up the whole program.

The rational-choice Marxians recognize that the lack of a mechanism in functionalist and structuralist theories is due to the lack of *intentional actors*, and they propose to remedy this by providing Marxism with "microfoundations" (something that no doubt would be anathema to a classical Marxian). The microfoundations that are suggested by Elster reduce to nothing other than the application of game theory. This application is seen as a way to bring rational agents into Marxian explanation. According to Elster (1982, p. 473), the use of game theory does not mean that we merely "*assume* that the cooperative outcome will be realized simply because there is a *need* for it; rather we exhibit *a causal mechanism whereby it will be achieved.*" Elster (1988, pp. 227–28) characterizes the relationship between the state and capital as an interaction among at least three strategic actors—workers, capitalists, and the state—although he recognizes that it is problematic to treat these aggregates as actors.

For Roemer, the microfoundations of Marxism should consist in "deriving the aggregate behavior of an economy as a consequence of the actions of individuals, who are postulated to behave in some specified way" (Roemer 1981, p. 7). For example, in his chapter on the falling rate of profit, Roemer assumes that a technical innovation is introduced only if it increases profits for an *individual* representative capitalist. Roemer (1985) also invokes game theory to provide a micro-theory of revolutions and conflicting ideologies. For example, he uses game theory to argue that it is rational for a revolutionary entrepreneur confronting an entrenched leader to adopt a progressive ideology (favoring the poor over the rich), while the ruler will rationally choose a conservative ideology. Selective adaptation ensures that the progressive strategy will be used by the successful revolutionary (Roemer 1988, p. 244).

[23]This section draws on Heijdra, Lowenberg, and Mallick (1988).

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Other Marxian scholars have also attempted to enhance the explanatory power of their models by adopting microfoundations. Wallerstein and Przeworski (1988) view the relationship between wages and profits as a strategic game between workers and capitalists. Taylor (1988) uses an explicitly microeconomic theory of collective action, based on Olson's seminal work, to explain revolution. Olson's approach suggests that the most successful collective action takes place when incentives apply selectively to individual members of interest groups depending on whether or not they contribute to the provision of the collective good. Without such selective incentives, collective action is more likely to occur in small groups than in large ones, or in large groups that are federations of smaller ones. In the context of revolutionary collective action, Taylor argues that rebel mobilization requires existing networks of local communities to provide effective social sanctions and to facilitate spontaneous conditional cooperation. In essence, community membership creates an iterated game in which participation in rebellion is conditional on others continuing to participate, which in turn is guaranteed by continuing membership in the community (Taylor 1988, pp. 68–69).

The rational-choice Marxians, however, still fail to identify the chief distinguishing feature of neoclassical economics that really separates it from Marxian theories of institutional change. Elster, for example, accuses neoclassical economists of being as guilty of objective teleology as are Marxians. He singles out Posner's theory of the common law and North and Thomas's theory of history as functionalist explanations. In fact, at a superficial level, the argument could be made that invisible-hand explanations of institutions, like their Marxian counterparts, are essentially functionalist. After all, neoclassical economic theories of institutional arrangements attribute the evolution of new institutions to the fact that they maximize the social dividend.

However, a more careful examination reveals that the key difference between neoclassical explanations and functionalist theories is that the former provide a general account of the actual mechanisms of social adaptation (Gray 1987, p. 43). Intentional maximizing behavior of individuals is sufficient to yield predictable outcomes, including (unintended) configurations of rules and institutions. Thus, neoclassical economic theory tells a story about how acting, choosing individuals bring about social outcomes, and thereby avoids the caveat of functionalism. To the extent that invisible-hand explanations are causal-genetic stories about how individual actions unintentionally lead (or might have led) to the emergence of some institutional structure, they must be distinguished from functionalist expla-

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nations that focus not on the *process* through which the structure emerges but on the processes that *maintain* the structure once established (Langlois 1986, p. 248). Both the Posner and the North-Thomas theories are based on the idea of a catallaxy of self-interested individuals, out of whose rational maximizing behavior emerge rules or institutions that provide the foundations for a spontaneous social order.

Neoclassical economists, therefore, do not need to adopt some device such as game theory to escape the explanatory vacuousness of functionalism, precisely because their theories already possess the microfoundations that some Marxians are apparently now finding it necessary to emulate. This very attempt to imitate methodological individualism on the part of Marxian scholars like Elster and Roemer provides strong testimony to the scientific superiority and expanding empirical content of the neoclassical approach, when compared to the structuralist alternative.

In the realm of political theory, too, there are Marxians whose work bears a remarkable resemblance to that of the interest group and rent-seeking schools of public choice. Marxian writers who are exponents of the structuralist political theory of Poulantzas essentially embrace a conception of politics that approximates the interest group pluralism of public choice. According to Poulantzas (1974), there are many levels of social activity within the polity, each of which encompasses a possible locus of conflict between competing fractions of capitalist and labor classes. Theorists in this structuralist tradition have been concerned to identify those groups of workers and capitalists whose interests may be contradictory within modern capitalism. A central assumption in this literature is that workers and other groups respond rationally to their objective interests. Class interests are clearly distinguished from the empirical concerns of particular members of classes (Calhoun 1988, p. 156). Although the microfoundations of collective action are not addressed by the Poulantzasian structuralists, policies enacted by the state are viewed as outcomes of a complex process of interaction between fractions of classes, or interest groups, which is not necessarily inconsistent with the public choice approach (Dollery 1988).

Conclusion

I have argued that Marxian, radical, and institutionalist economics do not possess the expanding empirical content that characterizes neoclassical economics. The reason is that these structuralist theories start with the group or class, without a theory of individual purposive

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behavior. Therefore, the structuralist approach lacks any conception of an intentional actor and, consequently, relies on functionalist explanations. Aggregate outcomes are explained by virtue of the fact that they are (must be) functional to the survival of the ruling class, for example, or the capitalist system. Functionalist theories are inherently untestable and, therefore, unscientific according to positivist criteria of what constitutes science.

On the other hand, neoclassical economics, which is based on methodological individualism, starts with a conception of the individual as an acting, choosing, rational agent. Building upon this foundation, neoclassical economic theory has been used successfully to explain an increasing number of social phenomena, ranging from institutions, law, and politics to ideology and history. Institutionalist and other nonneoclassical criticisms of these extensions of neoclassical economics are shown to be fallacious. Furthermore, some radical scholars have adopted the rational-choice microfoundations of neoclassical economics, testifying to the progressiveness of the neoclassical research program relative to its main competitors.

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Should We Fret about Our Low Net National Saving Rate?

Henry N. Goldstein

Introduction

Relative to most other industrial countries, the United States has recorded low ratios of saving and investment to GNP since the end of World War II. The official accounts show a further decline in the 1980s in the U.S. net saving rate, which counts the U.S. budget deficit as a negative component. Many analysts maintain that this recent decline in the ratio of net national saving to GNP threatens accustomed improvements in our national living standards and makes the United States highly vulnerable to a cutoff of foreign investment funds.

Thus, Alan Greenspan (1989, p. 15) has argued:

> The U.S. [budget] deficits of recent years are threatening precisely because they have been occurring in the context of private saving that is low by both historical and international standards. Historically, net personal plus business saving in the United States in the 1980s is about 3 percentage points lower relative to GNP than its average in the preceding three decades. . . .
>
> Under these circumstances, such large and persistent deficits are slowly but inexorably damaging the economy. The damage occurs because deficits tend to pull resources away from net private investment. *And a reduction in net investment has reduced the rate of growth of the nation's capital stock.* This, in turn, has meant less capital per worker than would otherwise have been the case, and

Cato Journal, Vol. 9, No. 3 (Winter 1990). Copyright © Cato Institute. All rights reserved.

The author is Professor of Economics at the University of Oregon. He wrote this paper while he was Visiting Economist with the U.S. Department of State, Bureau of Economic and Business Affairs, Planning and Economic Analysis Staff. The views expressed are not necessarily those of the U.S. Department of State. He is indebted to Frank de Leeuw, Bill Dewald, Jo Anna Gray, Tom Hall, Dan Ihara, Bill Niskanen, Kathleen Scanlon, Barry Siegel, Herbert Stein, George von Furstenberg, and Michael Ulan for their many useful comments and suggestions.

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> this will surely engender a shortfall in labor productivity growth and, with it, a shortfall in growth of the standard of living [italics supplied].

In the same vein, George N. Hatsopoulos (1989) has written:

> The U.S. economy during the late 1980s has devoted a far higher share of national output to consumption, and a lower share to investment and saving, than in any comparable period of this century. The result: Despite very recent gains, we aren't saving enough to maintain the growth in living standards we've come to expect.[1]

And the International Monetary Fund (1989, p. 41) has asserted:

> Among the deficit countries the task of raising domestic saving is particularly urgent in the United States, given the magnitude of that country's reliance on external funds and the sharp decline in the private saving rate in the past several years. These factors, coupled with a *net investment performance* that is poor by historical standards and in comparison to other industrial countries, underscores the vulnerability of the U.S. economy to a possible reduction in the inflow of foreign saving [italics supplied].

This paper will explore issues raised by each of these three statements. We begin with Hatsopoulos (1989) who claims to define consumption "the way the U.S. government does: [as] all purchases of goods and services by households and government, except purchases of houses by individuals and purchases of plants and equipment by businesses."[2]

This definition of consumption seems too broad. Along with inventory accumulation, it also counts as consumption: (a) household purchases of durables; (b) government outlays for social capital (e.g., schools, highways, sewage facilities, and airports); (c) spending on education and training by households, government, and business; and (d) R&D outlays by business and government. Because such items augment the economy's productive potential, it is logical to count them—at least in part—as investment outlays.[3] Moreover, if these components of expenditure and product are relatively more important in the United States than in other industrial countries,

[1]For a detailed discussion, see Hatsopoulos, Krugman, and Poterba (1989). Similar views are expressed by Feldstein (1988) and by *The Economist* in "The Wasting Disease" (1989). The summary line atop *The Economist* article reads; "Behind the fuss over the dollar and the trade deficit lies a far bigger fear: that America is giving up investment."

[2]Hatsopoulos should have included increases in business inventories as a component of domestic investment. His definition of "consumption" implicitly includes the net budget deficit of all sectors of government as a negative component of saving.

[3]See Lipsey and Kravis (1988) and Eisner (1989).

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counting them as investment (and in-kind saving) would raise the saving-investment ranking of the United States among the G-10 countries.[4]

Although the issue of definition and classification is important, I stress different considerations in this paper. Specifically, I proceed along the following lines: (a) I note that the very sharp dip in the net U.S. saving rate in the 1980s far exceeds the drop in the gross U.S. saving rate—the ratio of gross saving to GNP; (b) I argue that the gross saving rate—and its counterpart in a closed-economy setting, the gross investment rate—is a far more important influence on economic growth than the net saving rate, *when both gross and net saving rates are measured in their customary way*; (c) observing that there has recently been a rise, not a drop, in the ratio of (conventionally measured) real gross domestic investment spending to real GNP, I argue that it is this *real gross investment ratio* that is critical for future economic growth; (d) I argue that the deterioration of the U.S. external creditor position associated with the recent string of current account deficits poses no significant threat to continuing increases in U.S. living standards; and (e) contrary to the IMF's staff assessment, I argue that the large current-account deficit does not increase the economy's vulnerability "to a possible reduction in the inflow of foreign saving."[5]

[4]In an extremely interesting exercise, Lipsey and Kravis (1988) estimate that in 1980, on a narrowly defined "nominal basis," U.S. gross investment as a percentage of GNP was only 84.1 percent as high as the weighted average of the corresponding percentage for a group of eight other industrial countries (Japan, Belgium, Denmark, France, Gemany, Italy, the Netherlands, and the United Kingdom). But when they make comparisons using a broad definition of investment spending that includes as investment expenditures on education, R&D, consumer durables, and military capital formation, and when they adjust for relative-price differences (thus comparing "real investment outlays to real GNP"), they estimate that the gross U.S. investment ratio was 99.1 percent of the average ratio for the other eight countries in 1980.

They conclude that "the U.S. is close to the average of other developed countries in the degree to which it has used its income for forward-looking purposes—capital formation in a broad sense." And noting further that the price of capital goods has been relatively low in the United States and that the United States is a high-income country, they conclude that in real terms, the U.S. has invested "more per capita than almost all the individual countries."

[5]This general approach to questioning the conventional wisdom regarding the problems posed by the low net saving and investment ratios in the United States has been forcefully set forth in an insightful editorial in the *Wall Street Journal* entitled "The Quality of Investment" (1989). In addition to arguing that the critical magnitude to focus on is real gross investment, to noting that conventionally measured consumption has many investment-like components (e.g., "your son's engineering education"), and to pointing out that depreciation allowances are suspect numbers, the editorial argues that the ending of distortions from high inflation, high tax rates, and the pre-1981 tax code has probably improved the quality of U.S. investment outlays. Thus the editorial

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A Thought Experiment

To appreciate why gross saving and investment rates are likely to be more important than net saving and investment rates for future economic growth, let us imagine that the U.S. economy is at its present stage of economic development but that the following simplifying conditions hold: The current account is balanced; net private saving is zero; the consolidated government budget deficit is zero; nominal gross investment just equals depreciation allowances, which amount to 10 percent of GNP[6]; and population and the labor force are fixed. If this state of affairs persisted for (say) 50 years, would we expect living standards to rise? Surely we would.

Our assumptions do not imply a stationary state because we have not ruled out continuing advances in science and technology. Thus, the continuing replacement of old machinery by new machinery, implicit in ongoing *gross investment*, would still promote the introduction of new and better products and more efficient methods of production. In short, nominal net investment and nominal net saving—as conventionally measured in the national income and product accounts—need not be positive for the economy to experience growing per capita productivity and output.

Without advances in science and technology, new machines would be replicas of old machines and the only way to augment the capital stock would be by increasing the number of such machines. But once we introduce technical and scientific progress, the capital stock can be augmented not only by increasing the number of machines of the pre-existing type but also by replacing old machines with superior new machines. In principle, an allowance for the superior quality of new machines can be made in estimating real gross and real net investment (along with corresponding values for "real saving"). But in practice that allowance is bound to be very rough. Moreover, no such allowance is made in computing nominal gross and net investment ratios.

Note, also, that technological progress can take the form of a superior *final product* that emerges from the application of a variety of recent advances in science, design, engineering, and materials—as, for example, with Toyota's new Lexus car; Boeing's latest model jet airliner; or Compaq Computer's latest laptop computer. To produce such new products, companies may well require a certain range of

---

suggests that the incremental output to capital ratio is likely to be higher in the future than in the past.

[6]In the U.S. economy currently, depreciation allowances amount to about 11 percent of GNP and gross nominal investment outlays amount to about 16 percent of GNP.

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new machinery (e.g., dies, jigs, presses, and plastic molding machinery). In an engineering sense, this new machinery may be no more efficient than the corresponding specialized machinery used to produce predecessor final products. But only the new machinery has the special features needed to produce the new, improved final product. Thus, the gross investment that corresponds to the production and acquisition of such new machinery promotes real economic growth even though the new machinery is not itself intrinsically superior to the machinery that it supersedes.

Uncertainties about the Accuracy of Depreciation Allowances

Net national product differs from gross national product by the sum of depreciation allowances. In making quantitative comparisons, however, economists usually use GNP rather than NNP because they recognize that depreciation allowances are likely to be very rough estimates of actual wear-and-tear and obsolescence. More important, the extent of the error in estimates of depreciation will probably vary over time, depending on a variety of influences.[7] Relying on GNP comparisons avoids this difficulty.

Yet this recognition of the imprecision and arbitrariness of depreciation allowances, implicit in the profession's preference for comparisons of GNP rather than of NNP, often seems forgotten when saving comparisons are made. As the quoted passages above indicate, many analysts seem fixated on the net saving rate—net national saving divided by GNP. This ratio is suspect because its numerator is obtained by subtracting a highly unreliable total for depreciation allowances from a relatively reliable gross saving figure. Since the resulting difference—net saving—must also be unreliable, so too must be any ratio with net saving as the numerator.

In sum, gross saving and gross investment ratios are likely to be better predictors of potential growth in output and living standards

[7]Tatom (1989, p. 10) states: "The methods of estimating discard and obsolescence rates used in the national income and product accounts have not been altered since they were introduced in the late 1940s." Actually, some 15 years ago the Department of Commerce ceased to estimate depreciation on the basis of companies' IRS returns. Commerce then adopted a "useful lives procedure" under which each of several dozen different categories of new capital formation is given a different average estimated service life to which a straight-line depreciation procedure is applied (modified by a frequency distribution around the average). However, as Pieper (1989, p. 15) notes: "Depreciation is subject to a number of serious measurement problems. Little is known of actual service lives and rates of depreciation and even less is known of how these variables might change over time."

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than net saving and net investment ratios for two reasons. First, gross investment incorporates the influence of "embodied new technology" in a much more comprehensive fashion than does net investment. Second, gross investment and gross saving are not subject to the measurement errors generated by the subtraction of questionable estimates for depreciation.

Some Statistical Comparisons

Figure 1 plots the share of gross domestic investment spending financed by depreciation allowances, taking a four-year moving average of the annual ratios of depreciation allowances to investment spending. Whereas depreciation allowances financed about 55 percent of gross investment spending in the 1950s and 1960s, they financed about 70 percent of such spending in the 1980s. The "new-technology effect" associated with the capital equipment financed by reinvested depreciation allowances (as opposed to that associated with capital equipment financed by other sources) has thus become increasingly important in recent years.

Figure 2 compares the time paths of aggregate depreciation flows and net saving, both measured as fractions of GNP. The net national saving ratio—which, as a fraction of GNP, corresponds to that part of gross investment spending financed by flows other than depreciation allowances—fell sharply after 1973, whereas depreciation allowances as a share of GNP rose. Because the rise in depreciation allowances was less than the drop in net savings, there had to be some fall in the gross savings ratio.

Figure 3 plots four series: (a) nominal gross investment, (b) nominal gross saving, (c) nominal net investment, and (d) nominal net saving—each as a share of nominal GNP. The gap between the gross saving and gross investment exactly matches the gap between net saving and net investment. In each case, that gap measures net foreign investment—positive or negative—as a share of GNP and the corresponding current-account surplus or deficit. In years when gross (net) domestic saving exceeded gross (net) domestic investment, the United States ran a corresponding current account surplus; in years when gross (net) domestic saving fell short of gross (net) domestic investment, the United States ran a corresponding current account deficit.[8]

[8]Let I = gross domestic investment, F = net foreign investment (corresponding to the current account surplus), S = gross domestic saving, D = depreciation allowances, i = net domestic investment, and s = net domestic saving. Then, by definition, we have

$$(1) \quad I + F = S, \text{ which implies } S - I = F.$$

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Trends in these ratios are shown more clearly in Figure 4, which plots four-year moving averages of the same four ratios. Note the following three points:

1. The gross investment ratio—though a bit lower after 1982 than in the 1978–82 period—shows no secular decline over the broad period, 1953–88. Thus, if only the measured gross investment ratio is considered, the United States did not suddenly become a low-investment country in the 1980s.
2. The moving average of the gross saving ratio varies between 14.5 and 16.5 percent over the 1953–82 period but then dips noticeably in the most recent six years. Even so, the mean of the (moving average) gross saving ratio in these last six years was only 14 percent less than the mean in the preceding 20 years.
3. Both net ratios edge downward during 1953–81 before declining sharply after 1981. The net saving ratio fell considerably more sharply than the net investment ratio, however, as a large current-account deficit emerged. In contrast to the 14 percent drop in the mean gross saving ratio, the mean net saving ratio in the 1982–88 period was 61 percent below its value in 1953–82.

Figure 5 compares the ratio of nominal gross investment to nominal GNP with the ratio of real gross investment to real GNP. When the average price of investment goods falls relative to the price of other components of GNP, as occurred during the 1980s, the ratio of the two real variables will exceed the ratio of the two nominal variables. This relationship held in the 1980s largely because of the substantial fall in the cost of computers per unit of estimated computer power.[9] As Figure 5 indicates, there has been no evident secular decline in either gross investment series. If anything, there has been a slight uptrend. In particular, the ratio of real investment to real GNP averaged 15.9 percent during the 10 years of 1951–60 inclusive but averaged 17.6 percent during the 5 years ending in 1988[10]

Subtracting depreciation from both sides gives the following expression:

$$(2) \quad (I - D) + F = (S - D).$$

Using the definition of net investment and net saving, we substitute into (2) to get

$$(3) \quad i + F = s, \text{ which implies } s - i = F.$$

If the current account is in deficit so that F equals, say, -150, then gross saving falls short of gross domestic investment by 150, and net saving falls short of net domestic investment by 150.

[9]This point is discussed in some detail in Bailey and Gordon (1988). See also de Leeuw (1989).

[10]In a penetrating paper, de Leeuw (1989) points out that the conventionally measured value for "real investment spending" is significantly affected by the base year chosen

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Figure 6 contrasts movements in a four-year moving average of the net saving rate with the time path of the growth rate of potential GNP as estimated by staff members of the Federal Reserve Board.[11] The growth rate of potential GNP is stable at about 3.4 to 3.5 percent from 1953 through 1973 but then dips to about 2.8 percent with the advent of the first oil shock; it dips further in 1980 with the second oil shock and then remains stable at about 2.5 percent. The moving average of the net saving rate fluctuates around a fairly stable level from 1953 through 1981—varying from 6.5 percent to 9.0 percent—before dropping sharply in 1982 and subsequent years, with the advent of simultaneous declines in government and private saving relative to GNP.

Although the four-year moving average of the net saving rate has been unusually low for the past seven years, no corresponding fall in the growth rate of potential GNP has occurred. Evidently, the net saving rate, at least as generated by the official statistics, has little bearing on the path of potential GNP in a country with ready access to foreign capital and a stable free-market environment. As long as this environment persists the odds are good that profit-seeking enterprises will undertake gross real investment expenditures on a substantial scale regardless of the state of domestic net savings. By introducing improved technology, such gross investment outlays will continue to raise the economy's productive potential.

If domestic savings are insufficient to finance the desired level of gross investment spending, a country with the reputation and prospects of the United States will have no trouble tapping external funds from both foreign financial intermediaries and primary foreign lenders and investors. The corresponding real resource transfer will manifest itself in a current-account deficit and in a decline in the country's net international investor position. So long, however, as the domestic rate of return on the incremental real investment financed by external resources exceeds the interest or interest-equiv-

for the selection of "constant dollar" prices because of the combination of a sharply falling price trend for computers coupled with a big increase (however measured) in the quantity produced. To cope with this index-number problem, he constructs a special series to estimate real gross investment (actually, real nonresidential fixed-gross investment) using a "chain-weighted" price series as his weights. He finds that the ratio of this real gross investment to a corresponding estimate of real GDP rises significantly over the period from 1952 to 1987, and he concludes that this rising trend should promote continuing gains in U.S. output during the 1990s.

[11]See Hallman, Porter, and Small (1989, Appendix A, p. 25). The estimated figures are based on the methodology expounded in Clark et al. (1982).

Potential GNP is supposed to be a level of GNP that the economy can sustain in a given year without inducing—*ceteris paribus*—an acceleration or deceleration of the inherited rate of inflation. Estimates of such a variable are inherently tenuous, and my use of this particular series is not meant as an endorsement of its indisputable validity.

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FIGURE 1

DEPRECIATION AS A SHARE OF GROSS INVESTMENT
(FOUR-YEAR MOVING AVERAGES)

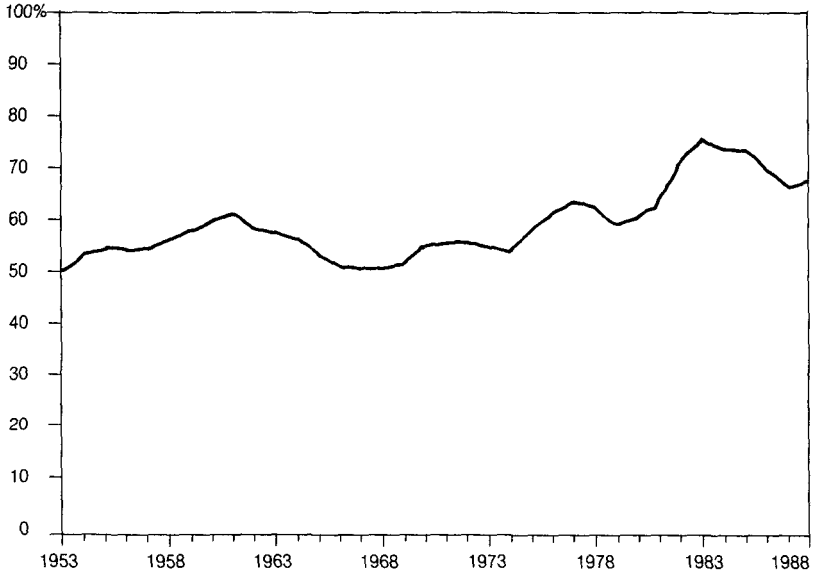

FIGURE 2

DEPRECIATION AND NET SAVING AS SHARES OF GNP

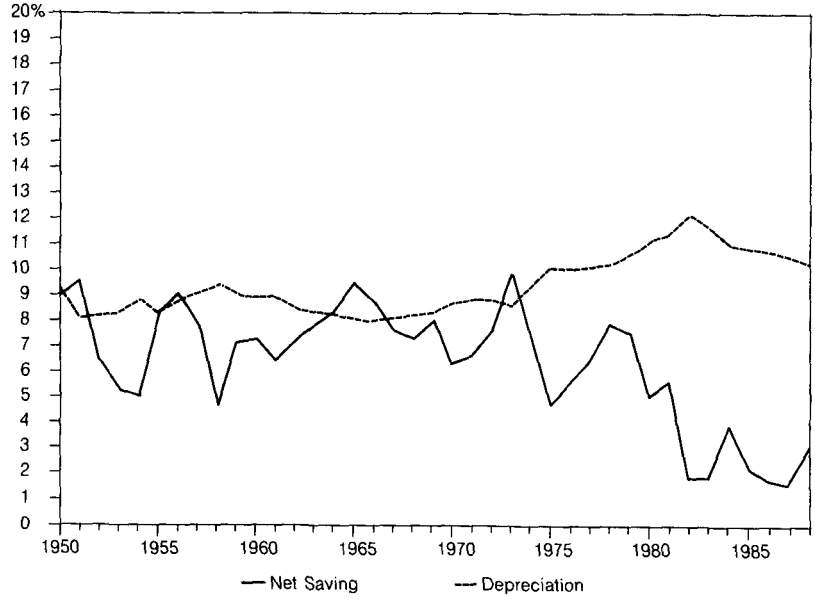

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FIGURE 3

SAVING AND INVESTMENT AS SHARES OF GNP

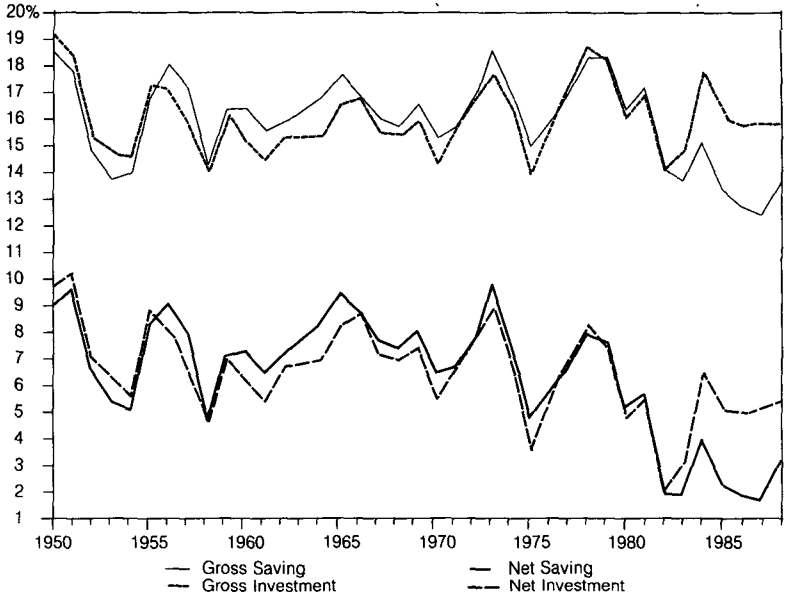

FIGURE 4

SAVING AND INVESTMENT AS SHARES OF GNP
(FOUR-YEAR MOVING AVERAGES)

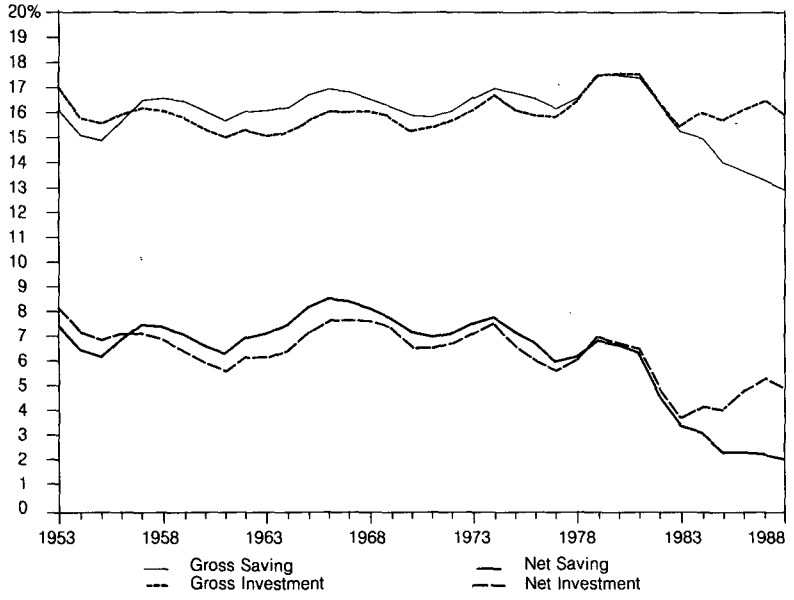

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FIGURE 5

REAL VERSUS NOMINAL GROSS INVESTMENT RATIOS

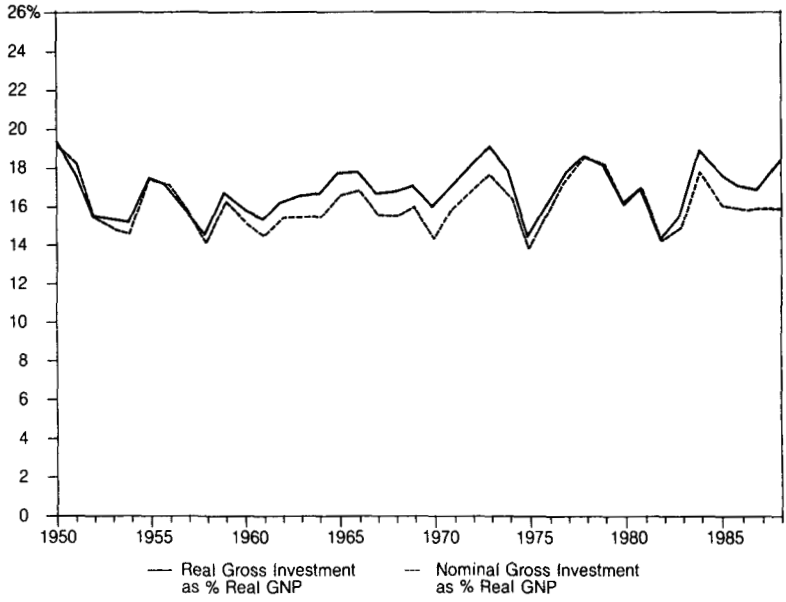
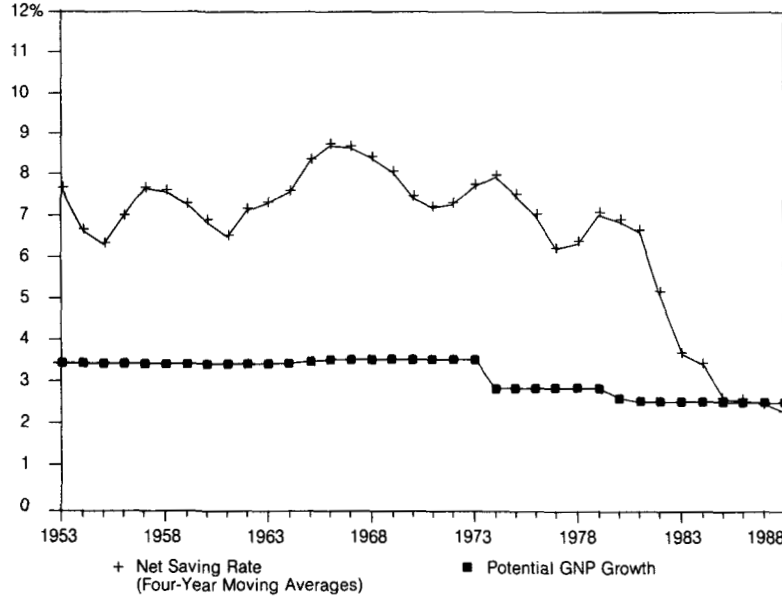


FIGURE 6

NET SAVING RATE VERSUS POTENTIAL GNP GROWTH



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alent cost of those external resources, the domestic economy will benefit. If the new embodied technology associated with gross investment is the key consideration, the most relevant savings and investment ratio for explaining future growth in a situation of substantial reliance on external resources would be the estimated ratio of real gross investment to real GNP.[12] And, contrary to the quoted statement by Greenspan, no significant slowdown in the growth of real capital per worker has accompanied the emergence of recent large government budget deficits and the dip in the overall net U.S. savings rate.

Output versus Claims on Real Income

The process just described does mean, of course, that an increasing share of our capital stock has come to be owned by foreign residents either directly or indirectly. It follows that we are likely to witness an increasing divergence in future years between our gross domestic product (GDP), which measures the total value of output produced by factors of production physically located in the United States, and our gross national product (GNP), which measures the value of the product that corresponds to gross income of U.S. residents. Even if the economy's output (or real income) continues to grow handily, an increasing share of it will accrue to foreigners rather than to U.S. residents.Thus, it can be argued, we should still worry about our low overall net saving rate.

Herbert Stein (1989) has responded to this concern by arguing that the inflow of foreign *financial* capital has enabled us to install additional *real* capital that would otherwise not have been put in place. In his view, the resulting additional flow of output and income that will result will enable us to readily service our incremental external debt. Others take a different view. For example, Benjamin Friedman (1988, p. 230) argues that "Reaganomics"—a sequence of tax cuts, budget deficits, high real interest rates, capital inflows, current-account deficits, and an adverse tilt in our net international investment position—"will profoundly affect how Americans live in the future, for hereafter an increasing share of our income will go abroad in the form of interest on what we owe." To resolve these

[12]For a similar explanation, see Tatom (1989) and Pieper (1989). See also de Leeuw (1989) who uses a relatively rigorous analysis that is quite independent of the embodied technology point that we stress to demonstrate that the ratio of real gross investment to real GDP has more relevance for future economic growth than the ratio of net real investment to real net national product—especially when there is a shift in the expected average life of real investment, such as has occurred in the United States recently with the increased importance of computers in the total mix of investment spending.

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divergent assessments, we need to assess whether the overall growth in the productive capacity of the U.S. economy during these recent years of consecutive large current-account deficits will enable us to cope with the additional net foreign claims that have accompanied those deficits. As we service our external debts in future years, are the adverse effects on our living standards likely to be severe or not?

As I argue below, they seem almost certain to be trivial: Prospective *net* debt service payments (i.e., gross external payments less gross external receipts) turn out to be quite small compared with prospective increments in the economy's real output.

The Capital Longevity Issue

In his recent "Statement to the Deficit Commission," Alan Greenspan (1989, p. 17) argues that budget deficits drive up domestic interest rates, which leads to a shift to shorter-lived investment goods. He goes on to state:

> Parenthetically, the resulting shift toward shorter-lived investment goods means that more *gross* investment is required to provide for replacement of the existing capital stock as well as for the *net* investment necessary to raise tomorrow's living standards. Thus, the current relatively high ratio of gross investment to GNP in this country is a deceptive indicator of the additions to our capital stock.

Does the transition to a shorter-lived capital stock necessarily handicap an economy's performance and potential? Frank de Leeuw (1989) has explored this issue in some detail using a formal mathematical model. His key conclusion is that for a given constant flow of gross investment, a permanent shift to shorter-lived investments leads to a temporary bulge in capital services and, hence, to a period of faster growth in potential output. Eventually, however, the growth rate in the flow of capital services dips below its initial level, as does the growth rate of potential output.[13] His analysis thus provides some support for Greenspan's concern. However, de Leeuw takes no account of the embodiment-of-new-technology argument. Because ongoing technological advances are embodied in new plant and

[13]See de Leeuw (1989, pp. A7, A8); see also his instructive Figure A1. To grasp the point intuitively, imagine that the economy switches over from investing a given amount of money each year in steel bridges to investing that same amount in wooden bridges. The total number of bridges in service will rise for a while, as will the economy's potential flow of services from bridges, but eventually the number of bridges will decrease as wooden bridges go out of service sooner than alternative steel bridges would have done. (The plot thickens if later-model bridges, whether of steel or wood, are able—because of technical progress—to contribute a greater flow of productive services per period than their respective wooden or steel predecessors.)

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equipment, it is possible that a reduction in average capital durability (which implies a more rapid turnover of the existing stock of capital) will promote, rather than retard, output growth. That would, in any event, certainly seem to be the case when applied to the main cause of reduced durability in the U.S. capital stock in recent years—the rapidly growing use of computers.[14]

Gramlich's Comparisons

Gramlich (1989) claims to find a strong positive association between "real national saving" and real economic growth in the United States. To derive real national saving, he subtracts depreciation allowances from the sum of gross private and government saving and divides the result by a price index. As estimated by Gramlich (1989, p. 34), the flow of real national saving in 1982 dollars rose from about $125 billion in 1955 to a peak of $240 billion in 1978; then it dropped sharply to average only about $100 billion a year for the six years of 1982–87 inclusive. Thus, he observes, real national saving has fallen sharply below the extension of its 1955–80 trend line.

Gramlich argues that this sharp decline in real national saving has been associated with a decline in the underlying U.S. growth rate for real output. He finds that "from the 1955 cyclical peak to the 1979 peak, the average annual real growth rate was 3.2 percent. From the 1979 cyclical peak to the 1987 peak, it was just 2.2 percent" (Gramlich 1989, p. 34, n. 4). On the basis of this comparison, Gramlich infers that the reduction in real national saving has, in fact, reduced our underlying rate of economic growth.

This inference seems unwarranted. The prolonged double-dip recession that occurred in 1980, 1981, and 1982 was a result of the strenuous efforts of the Federal Reserve to reverse the inflationary expectations that had gathered force during the previous two decades and that were intensified by the second oil-price shock. This *policy-induced* recession materially reduced the economy's average growth rate during 1979–87. Indeed, from 1979 to 1983—the first half of the "new epoch" in Gramlich's comparison—real GNP grew at an annual rate of only 0.7 percent. Small wonder that the entire eight-year period ending in 1987 shows such a weak performance.

[14]Even though he ignores this embodied technology point, de Leeuw (1989, p. 11) concludes, as this paper does, that real gross investment divided by real GNP (actually, de Leeuw prefers to divide by real GDP) is a better gauge of future potential output growth than real net investment divided by real net national product when the economy is experiencing, as it has in recent years, a shortening in the expected average life of new capital equipment.

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If, instead, we compute the average annual growth rate of real GNP for the five-year period beginning in the second quarter of 1984 and ending in the second quarter of 1989, we get a figure of 3.46 percent. The corresponding annual growth rate for real GNP from 1955 to 1979 was 3.08 percent.[15] This comparison—which seems more reasonable than Gramlich's—suggests that the economy's underlying growth rate has risen slightly since the new low-savings epoch began. Invoking a fall in real national saving to explain a fall in the nation's *underlying* growth rate is not a useful exercise if the underlying growth rate never fell in the first place.

But What about the Net External Debt?

According to the Department of Commerce, the United States had a *negative* net international investment position (NIIP) of $533 billion at the end of 1988 as against a positive position of $141 billion seven years earlier, at the end of 1981. This deterioration of almost $700 billion reflected, of course, the intervening current-account deficits.

Without doubt, the U.S. NIIP has deteriorated substantially in recent years. Nonetheless, as Eisner (1989), Ulan and Dewald (1989), and others have observed, the actual U.S. NIIP at the end of 1988 was surely much less negative than the official estimate, mainly because of the enormous undervaluation of U.S. direct investments abroad.

All direct investments abroad are measured at book value. Because of conservative accounting procedures and past inflation, this procedure markedly understates the true market value of most U.S. corporate assets held abroad. The same procedure also understates the true market value of foreign direct investment in the United States. But this latter undervaluation is relatively minor because most foreign direct investments occurred more recently than most U.S. direct investments abroad, so inflation and excessive depreciation allowances have had less time to create a gap between market values and book values.

In this regard, we should note that the official estimates of the year-end values for U.S. direct investment abroad were $308.9 billion for 1987 and $259.6 billion for 1986. Averaging these two figures, we get a mid-1987 stock estimate of $284.3 billion. After-tax income earned

[15]To compute growth rates, I used the formula

$$(\text{Initial value})(1 + g)^n = (\text{Ending value})$$

where n represents the number of years involved and g represents the growth rate to be solved for.

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by U.S. corporations on their direct investments abroad in 1987, *excluding capital gains from exchange rate and other effects,* amounted to $36.7 billion. Dividing this income figure by the mid-year stock estimate gives a return of 12.9 percent.

Corresponding year-end values for foreign direct investment in the United States were $261.9 billion in 1987 and $220.4 billion in 1986 for an estimated 1987 midyear average of $241.2 billion. After-tax income from these direct investments, excluding capital gains, amounted to $10.7 billion—a return, after corporate taxes, of only 4.4 percent.

It is not credible, however, to believe that U.S. direct investments abroad have been almost three times as profitable *per dollar of market value* as foreign direct investment in the United States. The most plausible explanation is the relatively greater undervaluation of U.S. direct investments abroad. If we adjust the estimated book value of U.S. assets so that the adjusted value also yields an after-tax return of 4.4 percent, that adjusted value at end-1987 would be $905.6 billion. Such an adjustment suggests that at the end of 1987 the United States was not—in any important sense—an international debtor nation.[16] During 1988, as it happens, the United States recorded a surplus of $2.3 billion on net investment-income transactions (which include all flows of interest, dividends, and direct-investment income between U.S. and foreign residents, both official and private).

Even so, the United States will almost certainly experience continuing current-account deficits over the next several years so that its net investment income will probably soon turn negative. Is the payment of that net investment income likely to impose a significant burden on the U.S. economy, as Hatsopoulos—and many others—have suggested?

Consider the following sequence of current-account deficits for the five-year period 1989 through 1993: $120 billion in 1989, $90 billion in 1990, $60 billion in 1991, $30 billion in 1992, and $10 billion in 1993. Such a continued reduction in our external deficits might occur through some combination of (a) persisting lagged effects of the depreciation of the U.S. dollar since early 1985 and (b) continued strong economic growth in Europe and Japan. Any such reduc-

[16]Other adjustments also make sense. The Department of Commerce values the U.S. gold stock at $42.88 an ounce. Its true market value is clearly considerably higher. Working in the other direction is the substantial overstatement of U.S. bank claims on Third World governments, and also the overstatement of U.S. government claims on such borrowers. Though mostly carried at book value, in many instances these claims are probably worth less than 25 cents on the dollar.

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tion also requires some rise in total U.S. saving relative to U.S. domestic investment spending simply because, as a matter of national income accounting, a nation's current account balance necessarily equals its total saving (inclusive of the government sector's budget surplus) less its total domestic investment spending.

Such an outcome seems quite plausible—especially if a continued easing of tensions between the Soviet Union and the United States leads to a significant reduction in U.S. military outlays that are not offset by corresponding increases in other categories of government spending. In that event, even with no new taxes, we might anticipate a material cut in the federal budget deficit over the next five years—hence, a significant rise in aggregate U.S. savings relative to domestic investment with positive effects on the current account.

If this sequence of current-account improvements were to materialize, the U.S. NIIP, aside from valuation changes, would still deteriorate by $310 billion between the end of 1988 and the end of 1993, leading to some corresponding combination of reduced U.S. assets abroad and increased foreign assets in the United States. At an interest rate of 10 percent, external servicing costs would rise by $31 billion per year; at an interest rate of 6 percent, costs would rise by $19 billion per year.

Could the U.S. economy cope with these costs? In 1988 nominal GNP amounted to $4,864 billion. If it grows at 6 percent per annum through, say, annual real growth of 2.5 percent and inflation of 3.5 percent, it would amount to $6,509 billion by 1993—$1,645 billion higher than its 1988 level. Since the projected increments in nominal debt service costs of $19 billion to $31 billion per year are less than 3 percent of the projected increment in nominal GNP, our collective incremental debt-service burden seems trivial.

Of course, one could make much more pessimistic projections. In particular, one could argue that the considerable improvement in the current-account deficit will cease or even be reversed. Indeed, most recent published projections, which rely on econometric models, show the U.S. current-account deficit increasing markedly after 1989, barring either a U.S. recession or a further significant depreciation of the dollar.[17] However, these projections seem suspect for three reasons: First, they assume that the recovery in U.S. competitiveness because of the dollar's decline from early 1985 until end-1987 will

[17]See Cline (1989) for a summary and discussion of two recent models—notably the Helkie-Hooper model and the so-called EAG model and for deficit projections based on those models and particular assumptions about the budget deficit and other "exogenous" inputs.

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generate no significant further improvements in the trade balance after 1989. Second, they assume that the United States will run fiscal deficits of $155 billion in 1989, $141 billion in 1990, $140 billion in 1991, and $135 billion in 1992—the Congressional Budget Office projections as of March 1989.[18] Third, they assume that Western Europe and Japan will experience some slowdown in their recent rates of growth.[19] In my judgment, all of these assumptions are suspect.

But let us suppose that these projections prove correct so that, over the next five years, the United States runs the following sequence of current account deficits: $120 billion in 1989, $130 billion in 1990, $145 billion in 1991, $155 billion in 1992, and $165 billion in 1993.[20]

A 10 percent nominal interest rate applied to this further cumulative deterioration of the U.S. NIIP implies additional net debt-service payments to foreign residents of $72 billion a year by 1993. But if nominal U.S. GNP rises by $1,645 billion between now and then on the plausible assumptions already indicated, the burden involved in servicing this incremental net external debt would still be less than 5 percent of incremental GNP. Even in this case, the transfer problem seems negligible.

Indeed, even if our (nominal) current-account deficit rose by $30 billion a year forever, no significant threat to U.S. living standards would emerge. If we achieve 6 percent *nominal* GNP growth by starting from an initial base of $5,000 billion (the level of nominal

[18]See Cline (1989, p. 11).

[19]In some instances, they also assume that the United States has a higher income elasticity of import demand than most of its major trading partners—the so-called "Houthakker-Magee" phenomenon.

Houthakker and Magee (1969) regressed the volume of U.S. exports on "rest of world" (ROW) real incomes and on relative prices, using data for the 1950s and 1960s. Their regressions found that the ROW income elasticity of demand for U.S. goods was relatively low as compared with the income elasticity of U.S. demand for imports from the ROW estimated from a parallel regression using U.S. real income and relative prices as explanatory variables. But that result was virtually inevitable given that U.S. exports grew more slowly than other countries' exports during the 1950s and 1960s. In fact, it is a spurious result.

The regressions failed to allow for nonprice developments that made non–U.S. goods increasingly competitive during that period. The current supply-side situation is quite different. For example, the quality gap between U.S. and foreign automobiles has clearly narrowed in recent years; similar observations apply to a wide range of other goods. Yet econometric models incorporating such questionable "income elasticities" of import demand are still relied on by respected analysts. See Cline (1989, p. 10).

[20]These figures are very close to those assumed in a central projection by Cline (1989, p. 15). That projection is based on two leading econometric models and on the exogenous assumptions noted in the text above. Similar projections are made by Howard (1989).

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GNP in the fourth quarter of 1988), the absolute yearly increase in U.S. nominal GNP comes to $300 billion in 1989, to $318 billion in 1990, to $337 billion in 1991, etc. Because these numbers are some 10 times the assumed $30 billion per year deterioration in the current-account deficit, the debt-service burden involved remains negligible.[21]

The Confidence Problem

The ongoing U.S. current-account deficit requires financing by some combination of reduced claims on the rest of the world by U.S. residents and increased claims on U.S. residents by foreign residents.[22] According to the International Monetary Fund (1989, p. 41), this ongoing financing requirement increases "the vulunerability of the U.S. to a possible reduction in the inflow of foreign saving."

Taken literally, the argument does not withstand examination: As it happens, the United States is no more vulnerable to a reduced inflow of foreign saving when it runs a current-account deficit than when it has a current-account balance or a current-account surplus. To see this, consider the simplified case of Illyria (whose currency is the I$). Suppose that Illyria has a current-account deficit of I$200 and a capital-account surplus of the same amount. Thus, it requires I$200 of net foreign saving per period.

Now suppose that foreign residents suddenly decide—in an ex ante sense—to reduce the rate at which they are willing to acquire claims on Illyria by I$300 per period. This planned reduction implies a corresponding excess supply of Illyrian dollars in the foreign exchange market with consequent repercussions on the exchange rate, interest rates, real incomes, exports, imports, and capital flows as the foreign-exchange market readjusts to a new equilibrium. The likely result is a hard landing.

Alternatively, suppose Illyria has a balanced current account and (necessarily) a balanced capital account as well. Illyria does not

[21]A recession would, of course, temporarily reduce nominal GNP growth. But it would also temporarily strengthen the trade and current-account balances by leading to a reduced demand for imports and by reducing interest payments to foreigners holding dollar-denominated claims at variable interest rates.

[22]Some analysts might object to this phrasing because it suggests that the current-account imbalance is necessarily the active force that induces net capital flows. The chain of causation could, of course, just as well run the other way—capital flows could be the exogenous factor that induces a matching current-account adjustment through the exchange rate or other channels.

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depend on a net inflow of foreign saving to finance its current-account deficit because it has no such deficit.

But once again suppose that foreign residents decide suddenly to reduce the rate at which they want to acquire claims on Illyria by I$300 per period. In this event, an identical ex ante shortfall of foreign exchange would materialize with impacts on the exchange rate, interest rates, and aggregate demand very similar to those experienced in the first situation. A given ex ante portfolio shift "against" assets denominated in Illyrian dollars hits the Illyrian economy just as hard whether it initially has a current-account deficit, a current-account balance, or a current-account deficit. Illyria's economy is just as vulnerable to "a possible reduction in the inflow of foreign saving" in all three situations. And so is the economy of the United States.

But the alleged greater vulnerability of the United States to the whims of foreign residents because of a persisting U.S. current-account deficit should be questioned from a much broader perspective. The U.S. economy is highly integrated with the rest of the world through flows of goods and services; transfers of managerial, technical, and entrepreneurial talent; shifts of financial claims; and ongoing transfers of technology. That openness exists regardless of whether the United States has a deficit or surplus on its current account. So long as the United States pursues policies that provide attractive business and investment opportunities, neither U.S. nor foreign investors are likely to suddenly shift out of dollar-denominated claims on a massive scale.

If the United States pursued different policies, both groups of investors would seek to shift their wealth into claims denominated in other currencies and subject to other national jurisdictions. But that (incipient) shift would occur on about the same scale regardless of whether the United States had been running a deficit or surplus on current account and regardless of the size of its pre-existing net creditor or net debtor position.[23] Dollar-denominated assets exist in

[23]The shift would be incipient—rather than realized—because in the aggregate it is impossible for a massive net capital outflow to materialize without a matching current-account surplus. Because of J-curve effects, however, it is virtually impossible for the trade account to change—in short order—from an annual deficit of $120 billion to, say, an annual surplus of $800 billion. But if a massive current-account turnaround cannot occur in the short run, neither can a *realized reversal* of net capital flows.

Instead, a sudden "flight from the dollar" would presumably lead to (a) sharply higher nominal U.S. interest rates and (b) a plunge in the foreign-currency price of the dollar. As a result of these valuation changes, investors would, *in a net sense*, be content to hold dollar-denominated claims, without—*on balance*—switching into assets denominated in other currencies.

Massive official intervention in support of the dollar would permit private investors,

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the trillions, and wealth-conserving and wealth-maximizing private owners—regardless of their nationality—constantly seek to benefit from prospective changes in after-tax returns on assets denominated in different currencies. Thus, potential capital flows between the dollar and other currencies are virtually unlimited.

In many instances, moreover, it is not even clear that we can distinguish U.S. from foreign investors in any meaningful sense. Manufacturing companies such as General Electric, Ford, General Motors, IBM, Exxon, and Compaq Computer generate one-third to one-half (or more) of their production and profits from their overseas affiliates. They are truly international in scope and vision. Financial institutions such as Citicorp, Nikko Securities, and National Westminster Bank have an obvious international perspective. If the dollar seems overvalued, all things considered, such global companies will rush to acquire DMs, yen, or other foreign currencies on a massive scale. If the dollar seems at an appropriate level, all things considered, they will maintain their present mix of currency claims. As they make these ongoing decisions, the U.S. current account is certainly a consideration that investors will take into account—but it is only *one* consideration.

It is by no means clear that current-account imbalances—even large and sustained imbalances relative to past levels—should be viewed as undesirable in an open and dynamic world economy. In any event, financial markets, massaged a bit by central-bank intervention, exert powerful pressures that tend to erase nonviable imbalances. In particular, if market participants, in the aggregate, begin to view a current account imbalance as unsustainable, their portfolio adjustments will induce prompt exchange-rate changes that will tend to narrow that imbalance.

Conclusion

We should stop fretting about the alleged dearth of U.S. saving, about the alleged threat to our future living standards stemming from our current-account deficit, and about our alleged vulnerability to a withdrawal of foreign investment funds. Upon examination, these concerns seem either chimerical or inconsequential.

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on balance, to switch out of the dollar; but by the same token it would lead to an offsetting capital inflow by foreign official institutions.

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Legal Obstacles to a Market for Employee Representation Services

George C. Leef

Introduction

The National Labor Relations Act (NLRA)[1] was passed in 1935 with a professed objective of guaranteeing that workers would have the freedom to decide whether or not they wanted union representation and collective bargaining. Section 7 of the NLRA states:

> Employees shall have the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection, and shall also have the right to refrain from any or all such activities, except to the extent that such right may be affected by an agreement requiring membership in a labor organization as a condition of employment as authorized in Section 8(a)(3).

Thus, aside from the final clause sanctioning "union shop" agreements, which make union membership a condition of employment, the law implies that employees are to have freedom of choice in deciding to unionize or not.

And freedom of choice there should be. The ability to choose among alternative goods or services in the *sine qua non* of consumer sovereignty. When consumers are free to choose, sellers must be ever-attentive to consumers' preferences. If sellers desire to succeed, they must discover precisely what consumers want and produce goods and services as efficiently as possible. Freedom of choice also minimizes the likelihood and severity of mistakes—decisions that leave consumers worse off. Because individuals know their own

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The author is a Policy Adviser for the Michigan Senate and an Adjunct Scholar with the Mackinac Center in Midland, Michigan.

[1]The text of the National Labor Relations Act is found in Title 29 U.S. Code, Sections 151–68.

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tastes, feelings, desires, and goals better than anyone else does, their choices are most apt to leave them satisfied with the results of free trade. However, if consumers should make choices that they subsequently regret, they can rectify their mistakes by recontracting in open markets.

Freedom of choice is just as important and beneficial to workers as it is to consumers. Workers benefit from freedom of contract because it allows them to freely negotiate with potential employers. And free trade in labor markets leads to mutual gains, just as in other markets.

Unfortunately, the NLRA does not ensure effective employee freedom of choice in the selection of bargaining methods and representatives. Far from protecting freedom of choice, the law actually restricts it and thus prevents the emergence of a market for employee representation services. The provisions of the rest of the statute and the case law emanating from it are often so much at odds with a policy of freedom of choice that the language of Section 7 has to be regarded as mere window dressing. This paper will explore the various ways in which the NLRA obstructs freedom of choice and will examine the consequences that follow.

That the NLRA is not really neutral with respect to the choices of employees is suggested by the language of Section 1. After asserting that

> The inequality of bargaining power between employees who do not possess full freedom of association or actual liberty of contract, and employers who are organized in the corporate or other forms of ownership association substantially burdens and affects the flow of commerce, and tends to aggravate recurrent business depressions, by depressing wage rates . . . and by preventing the stabilization of competitive wage rates and working conditions within and between industries.[2]

The statute then proceeds to declare that it is

> [T]he policy of the United States to eliminate the causes of certain substantial obstructions to the free flow of commerce and to mitigate and eliminate these obstructions when they have occurred by *encouraging the practice and procedure of collective bargaining* and by protecting the exercise by workers of full freedom of association, self-organization, and designation of representatives of their own choosing, for the purpose of negotiating the terms and conditions of their employment or other mutual aid or protection [emphasis added].

[2]The inequality of bargaining power justification for federal regulation of labor relations has frequently been attacked. See, for example, Hutt (1974) and Dickman (1987).

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If employees are to have freedom of choice, why have a law that is supposed to encourage collective bargaining? If collective bargaining is desirable, why bother with freedom of choice? Why give workers any choice if collective bargaining is so desirable?

As we shall see, the law is much more pro-union than it is pro-choice. Collective bargaining, while not mandated, is certainly favored. The drafters of the NLRA presumed that collective bargaining through unions with the power of exclusive representation was best. The law pays lip service to freedom of choice, but stacks the deck in favor of one of the possible choices.

Let us now examine the law's specific provisions that operate against freedom of choice for employees. This paper will discuss four main points: majority rule, the duration of the union's status as exclusive bargaining representative, restrictions on the flow of information, and the prohibition of company-sponsored unions.

Majority Rule and Exclusive Representation

Section 9(a) of the NLRA provides that

> Representatives designated or selected for the purpose of collective bargaining by the *majority* of the *employees* in a *unit appropriate* for such purposes shall be the exclusive representatives of all the *employees in such unit for the purposes of collective bargaining* in respect to rates of pay, wages, hours of employment, or other conditions of employment.

The law, therefore, establishes a decisionmaking procedure for labor union representation that is essentially the same as the procedure used for choosing political representatives in a democracy. The candidate who receives a majority of votes is victorious and then will be the sole representative of the people of that electoral district for a term in office. Similarly, if a union receives a majority of votes cast in a representation election, it then becomes the exclusive bargaining representative for *all* employees in the unit. Or, if a majority votes to have no union, there will be no union representation for *any* employee in the unit.

The question here is whether majority rule is compatible with freedom of choice. Majority rule means each person is entitled to participate in making a choice, but not that each is entitled to his or her own choice. Just as voters who preferred a losing candidate have to accept the majority's decision and put up with representation by someone they may vehemently disapprove of, so must losing voters in a union election. If union A wins a majority of the votes cast, it will represent all of the workers. Those who voted for union B or who voted against any union representation cannot have their preference.

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Contrast majority-rule political decisionmaking with market decisionmaking, in which people contract individually to purchase the goods or services they desire. No one is required to pay for any good or service he or she has not chosen. A person who desires the services of an investment adviser, for example, makes a choice, reflecting his or her own desires as closely as possible given the limits of personal knowledge about the market for this service. Another person seeking the services of an investment adviser may choose differently, perhaps preferring someone of more cautious temperament. A third person might prefer to have no investment adviser at all. This is an instance in which each individual can have a choice, and each would be worse off if compelled to accept someone else's preference.

Market decisionmaking permits the closest matching of the goods or services people want with the goods or services they get. To require that the decision on labor union representation be made politically by majority rule rather than individually by unamity rule virtually ensures that some employees will be compelled to abide by a decision they do not support. In other words, some workers will be worse off than if they had been free to choose on an individual rather than a collective basis.

Consider, for example, the following situation. A union is victorious in a National Labor Relations Board (NLRB) election, and it proceeds to negotiate a contract with the employer that leaves some workers worse off. These workers approach the company seeking to make individual contracts, and the company agrees, giving them better terms than under the collective bargaining contract. The union then sues to block the individual agreements on the grounds that it is, by law, the exclusive bargaining representative for all workers. If the union's suit succeeds, it is obvious that those disaffected workers have been made worse off.

This case is not merely hypothetical. It is *J.I. Case Co. v. N.L.R.B.*[3] The Supreme Court ruled in that case that the employer is forbidden to negotiate individual contracts with workers who desire to do so once a union has been certified. (This holding, incidentally, runs contrary to *dictum* in the Supreme Court's landmark decision in *N.L.R.B. v. Jones & Laughlin Steel,*[4] in which the Court read Section 9 as not precluding individual contracts.) The Court justified the infringement on individual freedom of choice by saying,

> [A]dvantages to individuals may prove as disruptive of industrial peace as disadvantages. They are a fruitful way of interfering with

[3]321 U.S. 332 (1944).
[4]301 U.S. 1 (1937).

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> organization and choice of representatives; increased compensation, if individually deserved, is often earned at the cost of breaking down some other standard thought to be for the welfare of the group.[5]

Speculative collective benefits thus triumph over the concrete benefits derived from freedom of choice.

The NLRA, however, does show some sensitivity to the problem of majoritarianism by requiring in Section 9(b) that the NLRB choose appropriate "bargaining units" of employees for the purposes of deciding upon union representation. In the language of the statute,

> The Board shall decide in each case whether, in order to assure employees the fullest freedom in exercising the rights guaranteed by this Act, the unit appropriate for the purposes of collective bargaining shall be the employer unit, craft unit, plant unit, or subdivision thereof.

In settling upon an appropriate bargaining unit, the Board's major criterion is to place within a unit employees who have common interests. For example, the NLRB has held that registered nurses should constitute a separate bargaining unit from other health care professionals in a hospital.

But if it would not be appropriate for all hospital employees to vote together on union representation on the grounds that there is an insufficient commonality of interests among them, why is it any more logical to have all the registered nurses vote as a unit? Certainly there can be as much difference of interests between two registered nurses when it comes to the question of union representation as between, say, a registered nurse and a lab technician.

If we are going to recognize differences in interests to the extent of permitting the registered nurses in a hospital to choose a different bargaining representative (or none at all) than the one chosen by the lab technicians or orderlies, why not carry this argument to its logical extreme and allow each employee individually to decide on this matter?

The answer usually given to this question is that if some employees form a union, others might choose to become free riders, that is, partaking of at least some of the benefits of others' collective action, but giving no support to it. The result could be an erosion of support for and the eventual demise of the union. Some commentators have found this line of reasoning to be persuasive (Pulsipher 1966), while others maintain that the possibility of free riding does not justify requiring all to go along with the vote of the majority.

[5]321 U.S. 332, 338.

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Taking the latter side, Moorhouse (1982) argues that not only do most union services fail to qualify as true public goods, but that compelling all employees to support a union voted for by a majority of their fellow workers "solves" the free-rider problem only at the expense of creating a "forced-rider" problem. According to Moorehouse (1982, p. 628):

> What seems more probable is that those who refuse to support the union (if given the opportunity) do so either because of genuine philosophical reservations or because they expect to suffer economically as a result of union action. . . . Only the individual can assess the subjective benefits of union membership; no outside, objective measure of these benefits exists to be imposed on individuals without giving rise to unintended and detrimental side effects, e.g., rank and file apathy toward the union, corruption, and employer-union leadership discrimination against employees. Little attention has been focused on the welfare implications of the "forced rider." How do the benefits unions accord the majority of their members compare with the costs imposed on a minority by forcing them to support the union?

One important aspect of the "forced-rider" problem, which has engendered a significant amount of litigation in recent years, is the union's use of dues money to support political candidates and legislation that some members find objectionable. If union X spends 25 percent of the dues it collects to support political party Y, and union member Z abhors party Y, he is being compelled to help elect people he deems to be working against his own best interests.

The Supreme Court first dealt with this problem in *International Association of Machinists v. Street*.[6] The plaintiff in the case demonstrated that union dues were being used to help finance campaigns for federal and state candidates whom he opposed. The Court held that the union was not allowed to use its funds to finance political activity that any of its members opposed. However, the Court said nothing about what remedy would be appropriate.

More recently the problem of forced political support has arisen in *Communications Workers of America v. Beck*[7] and *Chicago Teachers Union v. Hudson*.[8] In *Communications Workers of America v. Beck*, the trial court appointed a Special Master to determine the extent to which the CWA was using union dues to finance political activity. His finding was that only 19 percent of the dues collected was being spent on activities directly related to collective bargaining. The

[6]367 U.S. 740 (1961).
[7]108 S.Ct. 2641 (1988).
[8]106 S.Ct. 1066 (1986).

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remaining 81 percent was being funnelled into political activities. The trial court later revised the figures slightly—to 21 percent and 79 percent—but it was still clear that Mr. Beck's union was using most of the money it collected from him for political purposes he found objectionable. The Supreme Court held that such use of dissenters' dues was illegitimate.

In *Chicago Teachers Union v. Hudson*, the plaintiff argued that more than half of her dues money was being improperly devoted to political activities of which she disapproved, and that the union's procedure by which objectors could seek refunds of a portion of their dues did not adequately protect her First Amendment rights. The Supreme Court held in her favor.

The debate on this issue is no longer whether forced political contributions are illegal, but how best to protect employees' rights. Any refund system is going to impose some burden on all objectors, intimidate some, and lead to litigation over the proper amount to be refunded. The Gordian Knot–cutting solution is obvious: Allow workers to choose their union affiliation, if any, *individually* and drop it if they do not like what the union does.

Even if a satisfactory procedure is found for protecting the rights of those who must accept union representation but dissent from its political activities, any number of other reasons remain as to why workers might believe the costs that the union imposes on them exceed the benefits they derive from the union. Some degree of "forced riding" with exclusive representation seems as likely as some degree of free riding without it. There is no way of measuring the disutility created by these two effects. However, it must be noted that any problems free riding might cause (and the author is not aware of any instance before the NLRA in which a union collapsed because of excessive free riding) can be readily solved.

Suppose that a union were established at some firm and succeeded in obtaining improved wages and benefits for the members. Suppose further that, over time, enough members decided to drop out of the union and become free riders—still receiving the higher wages and benefits resulting from collective bargaining, but paying no dues—that the union was so weakened that it was no longer able to negotiate wage and benefit increases. Certainly the employees would be able to understand what had happened and why. Nothing would now prevent them from reestablishing or revitalizing their union through a contract in which all agreed to remain members for at least a certain number of years. Voluntary action, then, can minimize utility losses resulting from free riding.

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On the other hand, the utility losses incurred by forced riders last as long as workers are represented by the undesired union. They can, of course, quit and find other employment, but that will usually involve substantial costs to them.

In summary, majority-rule unionism is not consistent with individual freedom of choice, and the utilitarian justification usually given for it is, at best, unconvincing.

The Duration of the Union's Status as Exclusive Bargaining Representative

A second important restriction on the employee's freedom of choice concerns the duration of the union's status as the exclusive bargaining representative. Once a union has been certified by the NLRB, it remains so for at least one year, as Section 9(c)(3) states that "no election shall be directed in any bargaining unit or any subdivision within which, in the preceding twelve-month period, a valid election shall have been held."

But conspicuous by its absence is any provision setting a maximum time period for the union's certification. Unlike contracts made in the market, which are either terminable at will or have a definite time limit and then are open for renegotiation if the parties see fit, a union's certification as exclusive representative is indefinite. It lasts until the union is decertified or has clearly lost its majority support.

The open-endedness means that a certified union can remain so for decades, even though most or all of the employees who originally voted for it have left the company's employment. Suppose that a union won a representation election at Acme Enterprises in 1954. Today probably very few of the original employees who desired representation by that union are still working at Acme. Nevertheless, the union chosen in the 1954 election is still the bargaining representative for all employees in the unit, despite the fact that the huge majority who were hired after 1954 have never had the opportunity to express their desires. To be bound by a decision made years ago by other people is hardly consistent with freedom of choice.

The law does allow the employees to petition for an election to decertify an incumbent union. To obtain a decertification election, the employee's petition to the NLRB must show that at least 30 percent of the members in the bargaining unit desire to have such an election. If, in the decertification election, a majority votes to decertify the union, then the union loses its representative status. Otherwise, it retains its position.

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There are several reasons for believing that the law here is inadequate to guarantee true freedom of choice. First, workers who are dissatisfied with their union's services and want either no union or some other union have to take the initiative to petition the NLRB for a decertification election. Employers may not file such petitions. To do so is to commit an unfair labor practice. Many workers, however, would not know that such an election is possible or, if they did know, would not know how to go about writing, circulating, and submitting the petition without assistance.

The NLRB and the courts have ruled that such assistance cannot come from the employer. For example, in one case, company officials told their unionized employees that they would be given medical and hospitalization coverage if the union were decertified. A supervisor called the regional NLRB office to obtain a copy of a decertification petition, which was then given to the employees to circulate and sign. The union complained, and after investigating, the NLRB concluded that the company had committed an unfair labor practice by its "aggravated intrusion upon the self-organization rights of the employees."[9]

Thus, what to most observers would appear to be action to facilitate freedom of choice is regarded by the NLRB as a violation of employee rights. The employer is allowed to respond to employee questions, but may not offer any unsolicited advice regarding decertification, or promote or participate in any way in the petition drive. The employer must not even do anything that would give the appearance of approval of the petition.[10]

After the petition has been returned to the NLRB and a decertification election set, the employer may express a preference as to the outcome, but may not act in such a way as to "interfere" with the employees' rights—for example, promising a wage increase if the union is decertified.

The legal asymmetry here is strong. A union is allowed to initiate an organizing campaign and to pour resources into it. The employer, however, is required to remain passive once the union has been certified. Almost any management involvement in the decertification drive risks an unfair labor practice charge. And once an unfair labor practice charge has been filed, it blocks any action toward decertification until the charge has been resolved. Freedom of choice is restricted if workers do not know that they can vote to decertify an unsatisfactory union or, if they do, do not know how to go about doing

[9]Allou Distributors, Inc., 201 N.L.R.B. 47 (1973).

[10]For a thorough discussion of the employer's position, see Peirce (1982).

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it. The union certainly will not bring the matter up, and management is forbidden to do so.

There is yet another reason why the legal procedure of decertification is objectionable from a freedom of choice perspective. Even if workers know that decertification is possible and know how to proceed, they may be deterred from initiating the petition out of fear of harassment by the union. Retaliatory actions by a union against members who assert their rights are illegitimate, but workers would probably not be familiar with such details of labor law. Even if they had been told that any union retaliation would be legally actionable, they still might decide that an attempt to decertify was not worth the risk. Litigation afterward would be slow, costly, and uncertain. Fear, whether well-founded or not, might lead many an unhappy employee to decide that living with an unsatisfactory union is preferable to trying to have it decertified.

Let us compare the situation facing workers in a unionized plant with that facing consumers of any market-provided service. If consumers are dissatisfied with the service or think it is too costly, they simply choose not to contract again with that provider. No petitions need to be signed and submitted to government agencies. There is no reason to fear retaliation from the disfavored provider. And most important of all, there is no need to persuade a majority of other customers of this provider to vote with you. Getting out of union representation that workers do not want is very much more difficult than it need be or should be.

The small (although growing) number of decertification elections held each year is evidence that suggests the costs and impediments in NLRA imposes to deter workers from exercising freedom of choice. In 1986, the NLRB conducted 857 decertification elections, in which a total of 36,221 employees cast ballots (NLRB 1986). With a total number of private sector union members and nonmembers covered by collective bargaining contracts at about 12 million, only 0.3 percent of those employees had an opportunity to vote on maintaining union representation that year.

It might be argued that this merely shows a phenomenally high degree of satisfaction with union representation services. That argument, however, seems implausible when one notes that a majority of those voting in representation and decertification elections in recent years have voted against the union.

The only way to find out how satisfied workers are with their union representation is to permit them to contract individually for this service if they desire it. Our current system of certifying a union indefinitely as the exclusive bargaining representative of all workers

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in the bargaining unit interferes with freedom of choice, and allowing decertification elections does not remedy the vice. The costs of arranging for such an election are so high that an incumbent union knows that it has a highly secure captive market. Freedom of choice is an illusion.

Information Restrictions

Freedom of choice is enhanced as decisionmakers acquire more and more information about the costs and benefits of the various options they face. Conversely, if they are prevented from acquiring information that they might regard as pertinent, their freedom of choice has been effectively restricted. Therefore, to the extent that federal labor law blocks or raises the costs to workers of obtaining information relevant to their decision on union representation, it necessarily limits their freedom of choice and leaves them presumptively worse off.

Promise of Benefit

One very important restriction on the flow of information to workers is the NLRA's prohibition against any promises of benefits from the employer to the employees if the union should be defeated. Section 8(a)(1) of the NLRA states that it is an unfair labor practice for an employer to "interfere with, restrain, or coerce employees in the exercise of rights guaranteed in Section 7." That is to say, employers are forbidden to do anything that could be said to interfere with, restrain, or coerce employees when it comes to choosing whether to unionize or not.

As we shall see, if the employer communicates certain kinds of information to employees, he will be held to have interfered with, restrained, or coerced them. Furthermore, even if the employer's communications do not amount to an unfair labor practice, his communications may invalidate the results of the representation election. In the 1948 General Shoe case, [11] the NLRB stated that its duty in conducting representation elections was to provide "laboratory . . . conditions as nearly as possible, to determine the uninhibited desires of the employees."

Communications intended by employers to bring certain facts or possibilities to the minds of employees may be declared to upset the NLRB's notion of "laboratory conditions" and thereby invalidate the election results.

[11] 77 N.L.R.B. 124 (1948).

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First, if employers give or promise to give any increase in wages or benefits when a representation election is pending, they violate the law. The prescription against grants or promises of benefits is so deeply ingrained that even the generally promanagement 1947 Taft-Hartley Amendments contain language prohibiting such conduct. Section 8(c), which was added to the law to protect employers' freedom of speech, states that "The expression of any views, argument, or opinion, or the dissemination thereof . . . shall not constitute or be the evidence of an unfair labor practice . . . if such expression contains no threat of reprisal or force or promise of benefit."

An illustrative case on the law's hostility to grants or promises of benefits is *N.L.R.B. v. Exchange Parts Co.*[12] Prior to a representation election, the company's management sent a letter to the employees. The letter reminded them of past benefit increases that had been obtained without a union; pointed out that "only the company can put things in pay envelopes"; and stated that for the upcoming year benefits would include a birthday holiday, a new system for computing overtime, and a revised vacation schedule. This letter was the first announcement of these changes, all favorable to the employees. The union lost the election and then filed unfair labor charges against Exchange Parts, arguing that its letter had "interfered" with the employees' right to unionize.

The NLRB found that the company's promises were made with the intention of inducing the employees to vote against the union and, therefore, violated Section 8(a)(1). The Fifth Circuit Court of Appeals reversed, however, holding that there had been no unfair labor practice since the benefits were promised (and in fact given) unconditionally and permanently.

The Supreme Court reversed. Justice Harlan, in his opinion for the Court, wrote,

> The danger inherent in well-timed increases in benefits is the suggestion of a fist inside the velvet glove. Employees are not likely to miss the inference that the source of benefits now conferred is also the source from which future benefits must flow and which may dry up if not obliged.[13]

But to whom is the information a danger? If the employer is prepared to better the pay, benefits, or other treatment of employees, letting them know that is hardly dangerous. The knowledge does not "interfere" with free choice. Rather, such a communication enhances freedom of choice by informing the employees that their choice is

[12]375 U.S. 405 (1964).

[13]375 U.S. 405, 409.

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not just between keeping the status quo or supporting the union with its set of promises and blandishments, but between the union and improved conditions without it. The only danger here is that the union will lose the election if enough workers decide that the company's promises are credible and offer a more attractive alternative than unionization. If freedom of choice is the key consideration rather than the success of unions, however, this danger is of no consequence.

Justice Harlan went on to defend his position by saying,

> The beneficence of an employer is likely to be ephemeral if prompted by a threat of unionization which is subsequently removed. Insulating the right of collective bargaining from calculated good will of this sort deprives the employees of little that is of lasting value.[14]

In other words, information about any improvements employers are willing to make is not worth having, since employers might fail to keep their promise, or even if they do keep it, they might refuse to make any future pay or benefit increases, once the immediate threat of unionization has been "removed."

The weakness in the Court's position here is glaring. Even if the union loses the election, the threat of unionization is not removed. It is only delayed for one year. The employees are free to petition for a new election one year after an election has been held, so if the employers fail to keep promises made during the campaign or for any other reason fail to keep the employees satisfied, they will probably find another organizing campaign in progress uncomfortably soon. The wiser employees would most likely be disinclined to believe anything employers would say this time around. Insincere promises or negligible benefit increases cannot stave off unionization for very long.

In fact, it may even be questioned if they help to stave it off at all. As one commentator has observed,

> Most union organizers do not consider the employer's economic advantage to be a major threat. In fact, organizers can turn a grant to their advantage by claiming that the threat of organization is responsible for the employer's action, thus strengthening a union's claim that it can improve working conditions. If unions do not consider the granting of benefits to be a major problem, the Board should not either [Hamilton 1981].

[14]375 U.S. 405, 410.

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Thus, if the Court's rule is premised upon the assumption that employer promises or grants of benefits are too powerful for the union to counter, it seems to be in error.

The *Exchange Parts* rule prohibiting any promises of benefits by the employer is certainly wrong when we take freedom of choice as the paramount concern of employees. During organizing campaigns, unions make promises to the workers as to what they will do or try to do for them. These promises do not interfere with or coerce them in making their decision on unionization. The information provided by the union, even though it may exaggerate the benefits to be had while understating the costs, is nevertheless useful to the employees.

Similar information from the company is likewise useful to employees in their attempt to estimate the costs and benefits of unionizing. To prevent employers from supplying information on the benefits they are willing to give in order to dissuade their employees from unionizing creates a legal asymmetry that is contrary to the interests of the workers.

It will be objected that allowing employers to promise their employees benefits in exchange for remaining non-union allows the company to "buy out" of unionization. That observation is incorrect. All the company can do is offer what it hopes the workers will regard as a better deal. Like any offeree, the employees are free to reject the company's offer of improved pay or working conditions and go with the union's offer if they conclude that doing so will make them better off. In essence, the union and the company are bidding for the allegiance of the workers. The law should not restrain or interfere with this process (to use the language of the statute) or try to manage the outcome.

A final point: It is perfectly legal for employers to attempt to manage their business in such a way as to keep employees content and thereby deter union organizing campaigns. Ordinarily, there is nothing wrong in employers announcing their decision to raise pay or improve working conditions. It becomes an unfair labor practice only if done after an election has been scheduled. Why should that matter? Why should the fact that 30 percent or more of the employees have indicated a desire to have an election over unionization suddenly silence the employer? The employees still have just as much interest in hearing what the employer is prepared to do for them. The only party involved that stands to gain from preventing any further employer promises of benefits is obviously the union. No doubt it helps unions win elections if the employees are kept from hearing what the company will offer to induce them to vote no. However, the

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law is not supposed to assist unions, but rather to ensure freedom of choice.

Threat of Reprisal

A second restriction on the flow of information to employees pertinent to their decision to unionize is the law's prohibition of "threats." Here we have the reverse of the rule against making promises of benefits. The law attempts to shield workers from hearing bad news as well as good news. Section 8(a)(1), it will be recalled, makes it an unfair labor practice for the employer to "interfere with, restrain, or coerce" the employees in their decision to unionize or not. To threaten the employees with the possible loss of jobs, pay, or benefits if they should decide to unionize has long been held to be an 8(a)(1) violation. Or, as with promises of benefits, even if the employer's conduct does not amount to an unfair labor practice, the NLRB may find that it has upset the "laboratory conditions."

The leading case on this point is *N.L.R.B. v. Gissel Packing Co.*[15] The company was facing a representation election, and prior to the vote, the management sent literature to the employees and made speeches arguing that the firm was in a precarious financial position and would probably be unable to withstand a strike. The result could be the plant's closure and difficulty for the workers in finding new employment. Furthermore, the union in question was called a "strike-happy" outfit. These communications evidently had their intended effect. The union lost the election and then filed unfair labor practice charges.

Did Gissel's management commit an unfair labor practice by telling employees they would be better off if they rejected the union? The Supreme Court thought so. Chief Justice Warren's opinion granted that employers are permitted to say whatever they want about unions, and they may make predictions about the negative effects they believe unionization would have. However, he continued, any such negative prediction

> must be carefully phrased on the basis of objective fact to convey an employer's belief as to demonstrably probable consequences beyond his control or to convey a management decision already arrived at to close the plant in the case of unionization. . . . We therefore agree with the court below that "conveyance of the employer's belief, even though sincere, that unionization will or may result in the closing of the plant is not a statement of fact unless,

[15]395 U.S. 575 (1969).

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> which is most improbable, the eventuality of closing is capable of proof."[16]

The difficulty with the Court's formulation is that in something as unpredictable as collective bargaining, nothing is "demonstrably probable." There certainly have been instances in which, after unionization, bitter strikes, plant closings, and unemployment have resulted. In any of these cases, though, would the employer at the time of the representation campaign have had evidence strong enough about the future course of labor-management relations to have been able to make such a prediction without having to worry about unfair labor practice charges? It is hard to see how this could ever be the case. The employer is no more able to show that adverse consequences are "demonstrably probable" from unionization than the union is able to show that adverse results (more on-the-job accidents, perhaps) are demonstrably probable from a failure to unionize.

The effect of *Gissel* is to make any employer's communications very risky if they deal with the possible negative results of unionization. The Court's palliative that the employer can avoid trouble simply by refraining from "conscious overstatements" is of little practical use. Even if employers believe that they are not overstating the danger of unionization, they cannot be certain that the Board and courts will agree. A rule that makes the permissibility of speech turn on a judicial assessment of the speaker's subjective beliefs is a rule that will deter a large amount of speech.

Charges and countercharges about the likely outcome of unionization can be rebutted by the opposing party, leaving it to the voters to decide where they believe the probabilities lie. If the company tells workers that unionization might lead to a plant closure, the union has every opportunity to argue that such an outcome is unlikely. The union could point to the company's financial position (if it is reasonably strong) or the union's history of maintaining tolerably good relations with employers (if that is the case) to weaken the persuasive force of dire predictions from management. Of course, it may be that the company is in a weak financial position and could not survive a strike. Or it might be that the union in question has a history of militantcy that has left some plants closed and workers unemployed. It would then be difficult to argue convincingly that management's talk about unionization hurting the workers was nothing more than campaign rhetoric, but that is precisely when the employees stand to gain the most from a discussion of the issue. As Judge Friendly said in his *General Electric* dissent,

[16]395 U.S. 575, 618 (citation omitted).

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> Congress had enough faith in the common sense of the American working man to believe that he did not need—or want—to be shielded . . . from hearing whatever arguments his employers or unions decided to make to him. Freedom of choice . . . after hearing all relevant arguments is the cornerstone of the N.L.R.A.[17]

Unfortunately, Judge Friendly's view of the law has not prevailed.

During Collective Bargaining

A third way in which the law restricts the flow of information has less to do with the employees' original decision whether or not to unionize than with their ability to evaluate the union's value to them once the union has been certified. This restriction is against the employer announcing to the workers, prior to the onset of collective bargaining, exactly what he is going to offer. The relevant case here is *N.L.R.B. v. General Electric Co.*[18] The case arose out of a strike against General Electric in 1960. Before negotiations began with the International Union of Electrical, Radio, and Machine Workers (IUE) in 1960, General Electric formulated what it called a "fair, firm offer" and undertook a campaign to "sell" its offer to the employees. The company's theory was that the typical collective bargaining negotiations (negotiations in which the union would have exceedingly high demands, the company would initially offer nothing, and after months of negotiations, agreement would be reached approximately where both sides knew it would be at the beginning) were not only a waste of time, but also made it appear that all wage and benefit increases were due solely to the union's bargaining prowess. General Electric wanted people to see it as "doing right voluntarily" and, therefore, sought to persuade the employees that whatever offer it put forth was fair and reasonable in light of business conditions. In previous years, this tactic had led to no difficulties, but in 1960 the company and the union could not arrive at an agreement, and the IUE called a strike.

The strike proved to be disastrous for the union. It was unpopular and quickly collapsed at most GE plants (Northrup 1964). Subsequently, the union filed unfair labor practice charges, claiming *inter alia*, that the company had refused to bargain in good faith with it, as mandated by Section 8(a)(5) of the NLRA. The case reached the Second Circuit Court of Appeals in 1969, where it was finally resolved. (The Supreme Court subsequently refused to hear the case.)

[17]418 F.2d 736, 771 (1969).
[18]418 F.2d 736 (2d Cir., 1969).

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There were numerous issues involved in the case, but the one that matters here was General Electric's policy of communicating its bargaining position directly to the employees. The NLRB found that GE had, given the "totality of the circumstances," failed to bargain in good faith with the union. The "fair and firm offer" approach, which was characterized by the NLRB as "take-it-or-leave-it" negotiating, was an important part of the determination.

The Second Circuit agreed. Judge Kaufman wrote,

> General Electric . . . chose to rely entirely on its communications program to the virtual exclusion of genuine negotiations, which it sought to evade by any means possible. Bypassing the national negotiations in favor of direct settlement dealings with local officials forms another consistent thread in this pattern. The aim, in a word, was to deal with the union through the employees rather than with the employees through the union."[19]

General Electric's conduct was designed, the court said, "to derogate the union in the eyes of its members and the public at large."[20]

The court did not hold that communicating directly to the employees about the company's bargaining position prior to negotiations with the union was necessarily an unfair labor practice in and of itself. If a company does so, however, it is taking a step toward a possible unfair labor practice charge. In the court's words, "We do not today hold that an employer may not communicate with his employees during negotiations. Nor are we deciding that the best-offer-first bargaining technique is forbidden. . . . We hold that an employer may not so combine 'take-it-or-leave-it' bargaining methods with a widely publicized stance of unbending firmness that he is unable to alter a position once taken."[21]

Thus, while the GE decision does not expressly forbid an employer from communicating a bargaining stance directly to employees, it makes such communication risky. Unions so fear this management tactic that they will almost certainly file an unfair labor practice charge against any firm that uses it. Even if the union were to lose on the merits of the case, it still would have created a costly legal battle for the employer. The absence of reported cases revolving around this same point of law subsequent to the General Electric case suggests that direct communications to the employees of the firm's bargaining position are deterred.

[19]418 F.2d 736, 759.
[20]418 F.2d 736, 756.
[21]418 F.2d 736, 762.

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Furthermore, the court's vague "totality-of-circumstances" language leaves employers uncertain as to exactly what they may or may not say, a point stressed by Judge Friendly in his dissent. That uncertainty is also likely to deter employers from trying anything like the GE approach. We get the sort of *chilling effect* that figures prominently in so many Supreme Court decisions regarding freedom of speech in other contexts. A digression into First Amendment theory is not in order here, but it is not obvious why employer to employee communications are entitled to little or no constitutional protection.

If the law deters such communications, that law makes it much more difficult for union members to assess the benefits of their union representation. Without knowing what the employer was offering voluntarily in the way of wage and benefit increases, the members may believe that all gains are due to the efforts of the union. Their demand for union representation might be significantly different if they were able to compare the employer's offer with the eventual collective bargaining agreement. If employees were not prevented from getting this information, some—possibly many—might conclude that the benefits of union representation are not worth the cost.

Summary

To summarize, the law is quite asymmetrical with regard to the ability to convey information to employees. As we have seen, employers face restrictions on their communication of promises to increase benefits to workers, on the communication of the firm's bargaining position going into negotiations, and on the communication of the possible adverse consequences of unionization. Unions, on the other hand, are subject to no such restrictions.

Surveying the state of the law, one cannot disagree with the assessment of one commentator, who wrote,

> As the situation stands today, management is at an extreme disadvantage in the unionization struggle. Management is put on the defensive as soon as organizational efforts are initiated. The [NLRB and court] decisions, while allowing expansive union expression, have highly restricted the range of permissible management communication, thus creating an unjustifiable double standard [Swift 1973, p. 81].

The stifling of employer communications increases the probability of union victory in elections and also strengthens the position of incumbent unions. The entire rationale of the NLRB's tight regulation of employers' speech during representation campaigns has come under devastating criticism (Getman, Goldberg, and Herman 1975).

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In the interest of promoting freedom of choice, all legal restrictions on communication between employers and employees should be eliminated.

The Proscription against Company Unions

Yet another way in which federal law interferes with freedom of choice is its proscription against company unions. Section 8(a)(2) declares that it is an unfair labor practice for an employer to "dominate or interfere with the formation or administration of any labor organization or contribute financial or other support to it."

The purpose of Section 8(a)(2) was to stamp out competition for employees' allegiance (and also dues) from company-sponsored unions. Prior to the passage of the NLRA, company-sponsored unions were common, and organizers for the American Federation of Labor (AFL) and the Congress of Industrial Organizations (CIO) often found that the workers thus represented had little interest in changing to one of their unions.

In fact, during the mid-1930s, many so-called recognition strikes occurred at plants where AFL and CIO organizers were able to get only a few employees to sign up with them in preference to the existing company union. The union's tactics would then be to have those relatively few employees strike, and the union would support them with "flying squadrons" of outside pickets whose sole function was to intimidate the majority of the employees who wanted to continue work under their current arrangements (Baird 1984). Such strikes, however, were costly and did not always succeed. Far better, from the independent union's point of view, was to simply have company-sponsored unions declared illegal. The NLRA did this for the independent unions.

The prohibition of company-sponsored unions was defended with the argument that the interests of employees could be served only by independent—and adversarial—unions. Company unions were denounced as mere management fronts. If that were so, however, it should have been easy for the independent unions to persuade employees to abandon their company unions. A blanket legal prohibition is hardly justified and is clearly antithetical to freedom of choice. If workers are the best judge of their own interests, why not allow them to decide what type of union is most satisfactory?

The law's hostility to freedom of choice was laid bare early on. *N.L.R.B. v. Newport News Shipbuilding*[22] involved an NLRB order

[22]308 U.S. 241 (1939).

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that the company's union be disestablished because it was supported by the firm. The Supreme Court upheld the order despite findings that the employees were apparently satisfied with the union, that they were free to join other unions if they so desired, and that the union had helped to solve labor disputes. This reading of Section 8(a)(2) reminds one of the way the Court reads the Establishment Clause—just as the state may have virtually no entanglement with religion, so must an employer have virtually no entanglement with a union. In the words of one writer,

> This rigid rule has meant that an employer may be found in violation if he asserts or defrays the costs of elections for a labor organization, helps in or is present at the drawing of its charter, arranges for its attorney, supplies a place . . . for its meeting, furnishes any direct financial support, no matter how meager, provides any indirect financial aid, or . . . allows the organization to use its safe, mimeograph machine, or telephone, or provides secretarial services.[23]

The courts have interpreted Section 8(a)(2) as prohibiting not only company-sponsored unions, as in the *Newport News* case discussed above, but even employee or shop committees. In *Cabot Carbon Co. v. N.L.R.B.*, [24] the issue facing the Court was whether employee committees that the employer had formed at several plants were company-dominated "labor organizations" within the law's definition.

The committees, established in 1943 at the suggestion of the War Production Board, consisted of two or three employees who were chosen by the employees. Each member served for one year. The bylaws of the committees stated that their purpose was to meet regularly with management to consider employee's ideas, to address grievances, and to discuss problems of mutual interest. The committee collected no dues, had no funds, and had never been involved in collective bargaining.

In 1954, the International Chemical Workers Union filed unfair labor practice charges against Cabot Carbon. The union maintained that the employee committees were illegal and sought an order disestablishing them. Ultimately, the Supreme Court agreed with the NLRB that the committees were, in fact, illegal employer-dominated labor organizations and ordered their disestablishment.

The employee committees were voluntary and evidently useful organizations. The union wanted them eliminated only because they occupied some of what it regarded as its turf. Whether the workers

[23]"New Standards for Domination and Support under Section 8(a)(2)," unsigned student note, *Yale Law Journal* 82 (1972–73): 512.

[24]360 U.S. 203 (1959).

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liked these committees was not an issue at all. Some might have preferred to have kept the committees and still had union representation. Others might have thought that the committees alone best served their interests. But, as we have seen throughout, freedom of choice is of very little consequence under the NLRA.

Section 8(a)(2) compels workers to choose between independent (and generally adversarial) unions or none at all. Certainly, however, it is conceivable that some type of company-sponsored union would find favor with many workers. The company union predominates in Japan. It might prove popular in the United States as well. By prohibiting any sort of company-sponsored labor organization, we shield independent unions from a source of potential competition, limit freedom of choice, and, as Baird (1987) has pointed out, stifle entrepreneurial discovery of the most desirable modes of labor-management relationships.

Conclusion

The National Labor Relations Act, the National Labor Relations Board, and the federal courts have established a regulatory system over the field of labor relations that is hostile to freedom of choice for workers. Union representation decisions are made collectively by majority vote rather than individually. A union once chosen remains the exclusive representative for the bargaining unit indefinitely. Decertifying an incumbent union is a difficult process, and since decertification elections are rare, only a very small percentage of unionized workers ever get the chance to vote either to keep or to oust their union.

The law restricts the flow of information from employer to employee in a number of ways, making it harder for employees to accurately assess the costs of unionization and advantages of remaining nonunion. Finally, the law prohibits any company-sponsored labor organization, whether or not such organizations might be favored by some workers. The law pays only lip service to freedom of choice. Under the law, as enacted, a system has emerged that "subordinates individual rights and values to group interests and values" (Petro 1973, p. 466).

The law's restrictions on freedom of choice have prevented the emergence of a market for employee representation services. For a market to function, individuals must be free to contract as they choose, the flow of information must not be hindered, and people must be free to offer any sort of product or service to consumers. Those conditions do not exist in the realm of labor relations today.

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Labor unions have long professed that it is their goal to take labor out of competition, but the NLRA serves to take unions themselves out of competition. Just as protected producer monopolies are contrary to the interests of consumers, so are protected labor union monopolies contrary to the interests of workers. The case for allowing the market to operate in this field is just as compelling as allowing it to operate anywhere else.

The legal changes that are necessary if we are to allow a market in labor representation services are as follows: First, the decision on union representation must be an individual decision. Section 9, which collectivizes this decision, should be repealed. Until that can be done, we could require periodic recertification elections as a second-best solution.

Second, restrictions on the flow of information from employer to employee should be eliminated. Employers should not be prevented from promising (or giving) benefits, disclosing their bargaining stance to the workers directly, or discussing the possible adverse effects of unionization. The flow of information, arguments, and rebuttals should be no less free when it comes to unionization than in political campaigns. Section 8, which has been interpreted to forbid communications of the types mentioned above, should be rewritten.

Third, the law's proscription against company-sponsored unions should also be eliminated. We cannot have truly free choice if the field is closed to some potential competitors. Section 8(a)(2) should be repealed.

Making these legal changes will place freedom of choice as the law's paramount consideration and will establish the necessary conditions for the emergence of a market for employee representation services. Of course, just as any market process is unpredictable, it is impossible to say exactly what such a market would look like.

Will existing unions insist on representing all workers in a "bargaining unit" (a legal concept that would necessarily disappear under a regime of free choice), or would some unions accept paying customers where there was less than unanimous support for the union? If two or more unions represent workers doing the same job, how will negotiations be conducted? Would unions advertise for customers as other businesses do? What type of contract would a union make with members? How will managements deal with workers who decide to drop out of collective bargaining and seek to make their own contracts? Will alternatives to the current style of unions be created? If so, by whom? Will some existing unions go out of business similar to the shake-out that usually accompanies deregulation? To these

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and other questions, the only possible answer that can be given is: We shall have to wait and see.

A few predictions, however, can be made with confidence. Operating in an environment of freedom of choice and open competition, unions will certainly become more member-oriented if they want to prosper. Union leaders often lament the decline, which has been apparent for more than a decade, in union membership. That decline might be reversed if unions were perceived more as organizations designed to satisfy customers than as bureaucratic monopolies.

We can also predict that the unions' organizing campaigns will be less vehement, shorn of their "winner-take-all" implications. Furthermore, there will almost certainly be a decline in litigation. Deregulating the field of labor relations will greatly reduce the sphere of authority of the NLRB and the federal courts. Success in labor relations, therefore, will depend far more on influencing individual workers than on obtaining favorable decisions from bureaucrats and judges.

Freedom of choice has been missing from labor relations for more than 50 years. It is now time to remove the legal obstacles to a market for employee representation services. Such a change will restore freedom of contract as a mutually beneficial device for resolving labor disputes.

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The Twin-Deficit Illusion

William G. Dewald and Michael Ulan

Introduction

Despite employment and income gains in the 1980s, is the United States in trouble because it has become the world's largest debtor? The common perception is that Americans have become spendthrifts, with private consumption and government deficits financed by loans from and sales of assets to foreigners. The inference commonly drawn is that future consumption will have to be cut back in order to service the nation's rapidly deteriorating net external wealth position.

So much depends on the underlying measures that it is surprising how little attention has been paid to their quality. Thousands of regressions have been run to estimate the relationship between the budget and current-account deficits. But the data are suspect because official measures of these magnitudes typically have not been adjusted for either inflation or changes in market values. This paper's main objective is to analyze the twin-deficit phenomenon using data that have been adjusted for inflation and market values.

The conventional wisdom is that there is a causal link between large U.S. fiscal deficits and current-account deficits. This observation seems confirmed by Figure 1. Such a relationship is theoretically possible if fiscal deficits raise real interest rates enough to induce a capital inflow. Nonetheless, there is considerable dispute about the historical relationship between current-account and fiscal balances. For example, the United States ran large fiscal deficits during both World Wars, but there was a current-account surplus during World War I and a current-account deficit during World War II.

Cato Journal, Vol. 9, No. 3 (Winter 1990). Copyright © Cato Institute. All rights reserved.

The authors are members of the Planning and Economic Analysis Staff in the Bureau of Economic and Business Affairs, U.S. Department of State. The views expressed in this paper are those of the authors alone and not necessarily those of the Department of State or the U.S. government.

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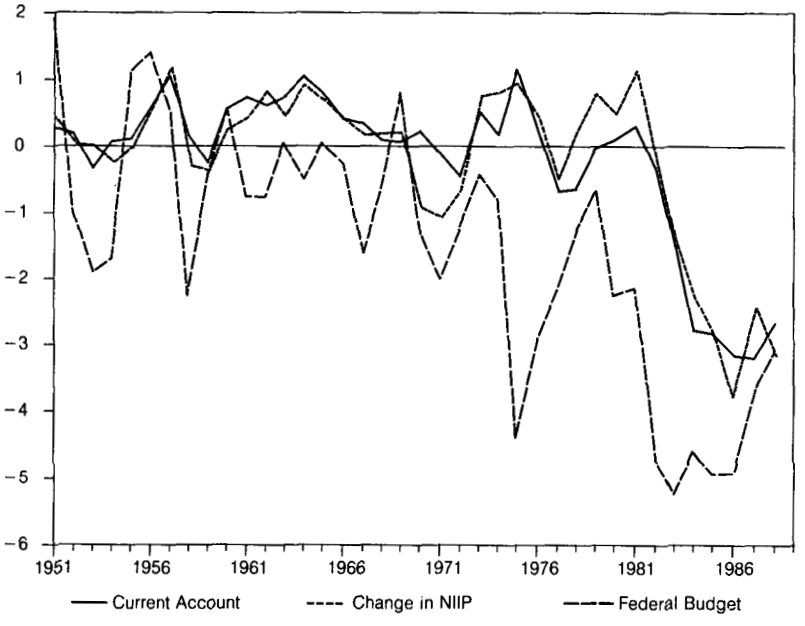
FIGURE 1

NOMINAL U.S. CURRENT-ACCOUNT BALANCE, CHANGE IN NIIP, BUDGET BALANCE RELATIVE TO GDP (PERCENT)



The present paper reexamines the twin-deficit relationship with both the budget balance and the current-account balance defined as changes in a net-asset position valued at market prices and adjusted for inflation. Such an approach has been used by Barro (1984) and Eisner (1986) in defining a real budget balance and by Cukierman and Mortenson (1983) in defining a real current-account balance. But, to our knowledge, no one has previously linked such budget and current-account balances. In our study with consistently defined real budget and real current-account balances, the twin-deficit association is not found to be statistically significant for the 1954–87 period, whereas there is a significant relationship in terms of the official nominal magnitudes.

Foreign Trade in the National Income and Product Accounts

The net flow of international trade in goods and services in the National Income and Product Accounts (NIPA) includes

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- the value of output produced for foreigners (exports),
- less the value of inputs to U.S. output and consumption produced abroad (imports),
- plus the income from foreign factors of production owned by U.S. residents,
- less the income from factors of production owned by foreigners in the United States.

This net flow of goods and services has a strictly current-production orientation. The concept of income on which such a measure is based does not take into account changes in the market values of existing assets or international transfers. The balance-of-payments definition of the U.S. current-account balance is broadened to include unrequited transfers. But both trade and current-account balances exclude changes in the foreign-currency market values of U.S. investments abroad, changes in the U.S.-dollar value of these investments as a result of exchange-rate movements, and changes in the market values of foreign investments in the United States.

A broader definition of the trade and current-account balances is arguably appropriate when considering the impact of international capital flows on national wealth and on a nation's ability to service net foreign claims on its production. In principle, the income resulting from increasing market values of U.S. foreign investments could support a net inflow of imported goods and services without decreasing national wealth or the U.S. net external wealth position. In fact, according to our estimates, a considerable part of the decrease in the official U.S. Net International Investment Position (NIIP) in the 1980s that was associated with persisting current-account deficits may have been offset by an increase in the market values of U.S. foreign investments. Such a market-value-adjusted current-account balance will be compared with the federal budget position in statistical tests reported in this paper.

"Real Budget" and "Real Current-Account" Balances

Definitions

Conceptually, the real federal budget deficit is not the nominal deficit divided by a price index. Such a direct measure, termed the NIPA-real budget deficit, is incomplete because it does not include changes in the real market value of *stocks* of outstanding federal assets and liabilities. A NIPA-real budget deficit can occur alongside a reduction in the real net debt of the federal government as in 1979

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when inflation was high. What happened was that inflation reduced the real value of the outstanding stock of government net debt by more than it increased because outlays exceeded revenues.

A *real* budget deficit is correctly measured by the increase in the *real* net debt position of the federal government. It depends not only on real flows of government expenditures and revenues but also on changes in real values of outstanding stocks of government assets and liabilities. In 1979, there was a NIPA-real federal budget deficit but, inasmuch as the real value of the outstanding net federal debt fell, the real budget position in 1979 is appropriately interpreted as a surplus.

One can define a "real current-account balance" as an analog of the real government budget balance. It is the change in the real U.S. net external wealth position.

- The change in the nominal net external wealth position is the total of the official, production-oriented current-account balance *plus* valuation changes that result from exchange-rate and asset-price changes.
- The change in the real net external wealth position is the total of deflated flows of exports, imports, and transfers, which are elements of the official current-account balance *plus* changes in the deflated market values of outstanding stocks of items included in the external wealth position.

The Link between Inflation Adjustment of the Budget and Current-Account Balances

Let us suppose that foreigners own $350 billion of short-term government securities that pay 9 percent interest a year and that annual inflation is 5 percent. Under these assumptions, the official nominal federal budget deficit would include $31.5 billion in interest payments to foreigners (.09 x $350 billion). Simply dividing these outlays by the price level, as is the NIPA standard, is misleading because it does not incorporate the decline in the real value of foreign-held federal securities resulting from inflation. The inflation-adjusted figure in terms of the previous year's price level is $13.33 billion (.04 x $350 billion/1.05). Essentially, (.09 − .05)/1.05 is the real interest rate at which the government borrows from foreigners, and .05/1.05 is the depreciation rate in the real value of the debt caused by inflation.

There is a corresponding inflation adjustment in the international accounts. In this example, the official nominal NIPA current-account balance would include a $31.5 billion debit reflecting the interest

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paid to foreigners. Dividing that element of the nominal current-account by the price index, as is the common practice, yields a NIPA-real current account debit of $30 billion. This figure is misleading because it does not account for the decline in the real value of the stock of federal debt held by foreigners. Taking that decline into account, we see that the inflation-adjusted interest outlay to foreign holders of federal debt in the current-account would not be $30 billion but $13.33 billion, the same as the correct real interest outlay to foreigners in the federal budget account.

Market Value Estimates of Net External Wealth Positions

The official U.S. net external wealth (NEW) position is called the U.S. Net International Investment Position (NIIP). It is compiled by the Bureau of Economic Analysis, Department of Commerce. The official NIIP was −$532.5 billion at the end of 1988, down from −$378.3 billion a year earlier.

Despite its common interpretation as a "net-debt" position, the NIIP includes not only debt but also equity holdings of real estate and businesses, plus holdings of foreign currencies and gold. The accuracy and meaning of the official measure is questionable. Portfolio investments are valued at market, but nonsecuritized debt and direct investments are valued at book value. Gold is valued at an arbitrary official $42.22 an ounce.

One may question whether gold, which is held in the United States, should be included as an international asset. If gold is included, about $100 billion would be added by valuing it at market prices as of the end of 1988. Regarding other items in the official NIIP, ownership crosses national borders. For those items, market valuation would cut roughly $50 billion from the book value of U.S. bank loans to foreigners, according to both Shearson-Lehman and to Salomon Brothers, but it would add perhaps $500 billion to the U.S. net foreign direct-investment position at the end of 1988.

Revaluations of direct investment positions to market were based on (1) investment-goods deflators, (2) movements in foreign and U.S. stock market indexes adjusted for exchange-rate movements, and (3) capitalization of direct-investment earnings. On balance, revaluations to market add hundreds of billions of dollars to the official U.S. NIIP.

Deflating the Twin-Deficit Statistics

Table 1 presents key current-account and federal-budget balance data as averages of annual data for the 1950s, 1960s, 1970s, and 1980s

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TABLE 1

U.S. FEDERAL-BUDGET AND CURRENT-ACCOUNT BALANCES: NOMINAL AND REAL:
ANNUAL AVERAGES
(BILLIONS OF DOLLARS)

	1982 Dollars							
	(1) Nominal Federal Budget Balance	(2) Nominal Current-Account Balance	(3) Change in Nominal NIIP	(4) Real Federal Budget Balance	(5) Real NIIP	(6) Change in Real NEW 1	(7) Real NEW 2	(8) Real NEW 3
1951–60	−0.2	1.1	0.7	11.8	0.5	2.1	7.4	10.2
1961–70	−3.6	3.3	1.8	9.2	2.0	6.6	2.7	6.8
1971–80	−33.2	−0.5	4.8	0.8	−1.5	22.1	6.3	−6.1
1981–87	−160.1	−76.7	−69.2	−133.7	−63.3	−58.5	−23.7	−1.4
1951–87	−43.8	−13.5	−11.1	−22.1	−11.7	−2.7	−0.04	2.7

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TABLE 1 (cont.)

ANNUAL AVERAGES RELATIVE TO NOMINAL OR REAL GDP
(PERCENT)

	Nominal Federal Budget Balance	Nominal Current-Account Balance	Change in Nominal NIIP	1982 Dollars				
				Real Federal Budget Balance	Change in Real NIIP	Change in Real NEW 1	Change in Real NEW 2	Change in Real NEW 3
1951–60	−0.06	0.26	0.17	0.79	0.03	0.14	0.50	0.69
1961–70	−0.48	0.44	0.24	0.44	0.10	0.31	0.13	0.32
1971–80	−1.76	−0.30	0.27	0.28	−0.05	0.78	0.22	−0.22
1981–87	−4.30	−2.08	−1.87	−3.90	−1.84	−1.70	−0.69	−0.04
1951–87	−2.74	−0.90	−0.74	−0.85	−0.49	−0.11	−0.03	0.11

NOTES: Budget data and period averages begin in 1954, not 1951.
Dollar figures are simple averages over the periods indicated. The normalization to GDP was effected by dividing the period-average dollar figures by the average nominal or real GDP for the periods indicated.
NEW 1: Revaluations based on investment deflators (Eisner and Pieper).
NEW 2: Direct investment valued to market via U.S. and foreign stock-price indices and the foreign-exchange rate of the dollar.
NEW 3: Revaluations based on discounted earnings on direct investment.

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through 1987. The large official current-account deficits in the 1980s in column 2 are reflected in large average changes in the official nominal NIIP in column 3. On the basis of 10-year averages, there was no apparent association between the nominal budget balance in column 1 and the nominal current-account balance in column 2, either in absolute terms or relative to GDP in the period before 1980. However, both budget and current-account deficits were very large for 1981–87.

Column 4 shows the real budget-balance estimates of Eisner and Pieper (1988). Because of inflation, nominal budget deficits (column 1) were translated into real budget surpluses in the 1950s through the 1970s. In the 1980s nominal deficits averaged over $25 billion more than real deficits, but even the real deficits appear large in absolute terms and relative to gross domestic product (GDP).

Columns 5–8 show changes in the various measures of the real U.S. NEW position. The decline in the official NIIP (column 5) and, to a lesser extent, the NEW position based on investment-goods deflators (column 6) were large on average in the 1980s and, thus, were associated with the large real budget deficits calculated by Eisner and Pieper. The average decline, however, in the real NEW position estimated on the basis of exchange-rate-adjusted comparative stock-market indices (column 7) was less than half as large as either of the former measures in the 1980s. There was essentially no decline in the NEW position estimated on the basis of discounted investment income (column 8).

Compared with the strong relation between the nominal current-account deficit and the budget deficit in the 1980s, the association in real terms is muted with respect to all of the inflation-adjusted market measures. Figure 2 presents annual real federal budget and current-account data relative to GDP, as well as the averages that appear in Table 1. The next section examines regression analysis of the twin-deficit relation in terms of these annual data.

Is There a Real Twin-Deficit Relation?

The foundations of the twin-deficit relationship have been questioned by a number of economists including Johnson (1984), Darby (1987), Niskanen (1988), and Evans (1985, 1986, 1988a, 1988b). They found no systematic association in the U.S. historical record between budget deficits and either interest rates or current-account deficits in nominal terms.

Our approach is quite different. We focus on the study by Roubini (1988)—one of the many studies that has found a significant twin-

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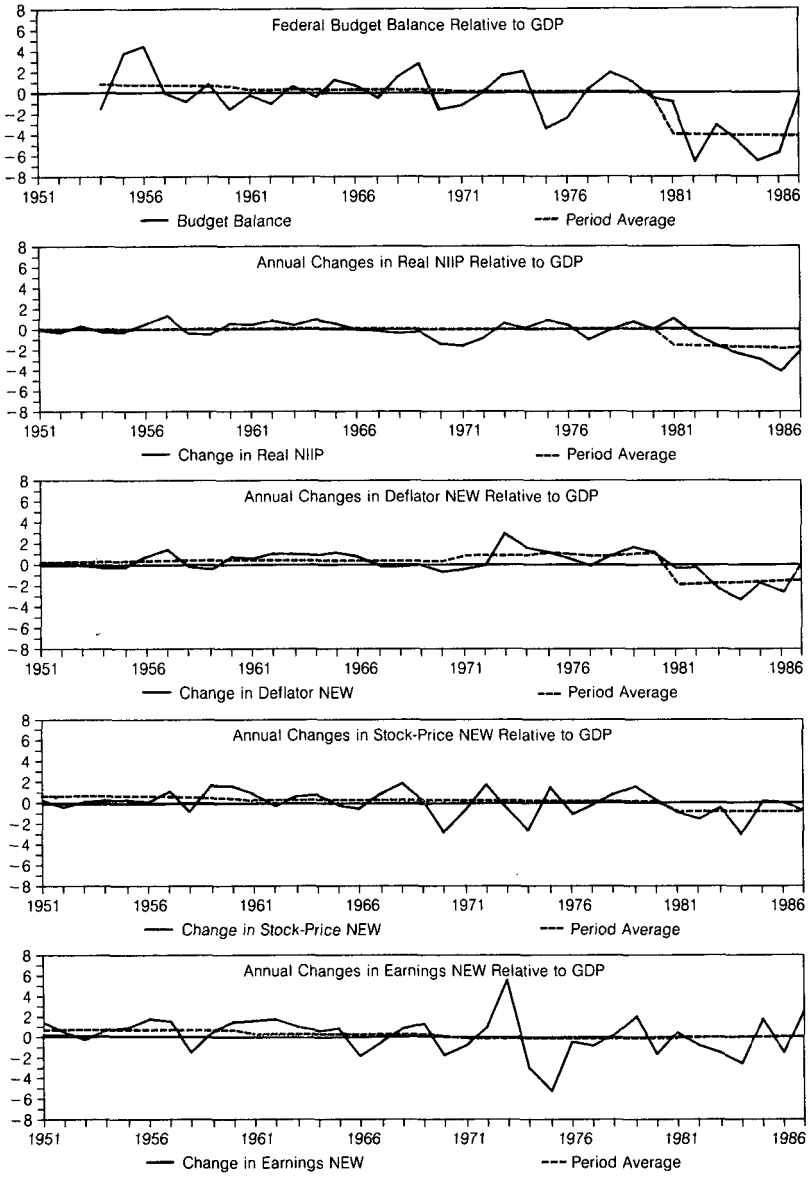
FIGURE 2

BUDGET AND CURRENT-ACCOUNT BALANCES RELATIVE TO GDP (PERCENT)



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deficit association. He examines the relationship between current-account balances and both the general-government budget position and domestic investment with all variables expressed in NIPA-real terms and normalized with respect to GDP. His empirical results for a number of OECD countries, including the United States, generally show that both budget deficits and domestic investment were highly significant in explaining current-account balances.

The fact that his data were not adjusted for inflation and market values offered an opportunity to plug corrected measures into his statistical specification. Our purpose is to see whether the twin-deficit relationship Roubini found for NIPA-real magnitudes for the United States would hold up after adjusting the statistics for the effects of inflation and changing market values on stocks of outstanding net government debt and the NEW position.

The Variables

Several measures of the federal fiscal position are used in the estimations. In replicating Roubini's equation, the general government deficit was used. In equations in which the ratio of the nominal current-account balance to nominal GDP is the dependent variable, the official NIPA federal budget deficit was used. In equations in which the ratio of the change in the real NIIP to real GDP is the dependent variable, the change in gross publicly held Treasury debt adjusted for inflation was specified. It was not adjusted for changes in the market prices of outstanding issues and, thus, can be likened to an "official" real deficit in the sense that it is based on the published official face value of Treasury debt. In equations in which the estimated "real current account balances" to real GDP are the dependent variables, the Eisner-Pieper federal budget-deficit data were used.[1] All of these data are presented in Appendix A. As in Roubini's work, the measure of investment was gross private domestic investment (fixed investment plus inventory change)—nominal or real consistent with the dependent variable.

The Estimations

In order for us to compare these new results with Roubini's in terms of both nominal and real variables, estimates were made over both the sample period he used, 1961–85, and over the entire period for which data are available, 1954–87. Symbols used are listed in

[1]Consistent with the wealth orientation of the present study, an implicit deflator, derived from the ratio of the constant-cost to current-cost stock of tangible capital found in the October 1989 *Survey of Current Business*, was substituted for the GNP deflator that Eisner and Pieper used to deflate their nominal federal asset and liability data.

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Table 2, and regression results appear in Table 3 for 1961–85 and Table 4 for 1954–87. Equation (1) is Roubini's. Equation (2) adjusts these estimates for serial correlation. The estimated coefficient of the general government budget deficit variable is insignificant in equation (2). However, when the *federal* deficit ratio is substituted for the general government deficit ratio, the estimated coefficients are significant in equation (3). Equations (8) and (9), respectively, present estimates for 1954–80 and 1954–87. In each period, given the gross private domestic investment ratio, there was a significant twin-deficit relationship between the nominal current-account and the nominal federal budget ratios.

Comparisons of equations (3) and (4) in Table 2 and of equations (9) and (10) in Table 3 reveal effects of inflation adjustment (but not market-value adjustment) on the twin-deficit relation. The real current account is measured by the change in the deflated official NIIP; the real federal budget balance, by the change in the deflated official stock of federal debt. Inflation adjustment uniformly *reduced* the estimated effects of investment and the budget deficit on the current account. Nonetheless, the coefficients of the budget balance were estimated to be significant. Based on these official statistics, the twin-deficit relation was estimated to be significant even in inflation-adjusted terms.

TABLE 2

DEFINITIONS OF SYMBOLS USED

X_1	Nominal current-account balance (sum of exports, imports, and transfers) divided by nominal GDP.
X_2	Change in real NIIP divided by real GDP.
X_3	Change in real Deflators NEW divided by real GDP.
X_4	Change in real Stock-Price NEW divided by real GDP.
X_5	Change in real Earnings NEW divided by real GDP.
Y_1	Nominal gross private domestic investment (fixed investment plus inventory change) divided by nominal GDP.
Y_2	Real gross private domestic investment (fixed investment plus inventory change) divided by real GDP.
Z_0	General-government deficit divided by nominal GDP.
Z_1	NIPA-based federal deficit divided by nominal GDP.
Z_2	Inflation-adjusted change in official publicly held Treasury debt valued at par divided by real GDP.
Z_3	Real federal deficit (Eisner-Pieper) divided by real GDP.

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TABLE 3

NOMINAL REGRESSION RESULTS, 1961–85

Dependent Variable	Constant	Investment	Deficit	Rho	R^2 (Adjusted)	D.W.
(1) X_1	Not Reported	$-0.51\ Y_1$ (-3.06)	$-0.61\ Z_0$ (-4.00)	OLS	0.42	0.86
(2) X_1	0.05 (1.72)	$-0.27\ Y_1$ (-2.24)	$-0.09\ Z_0$ (-0.64)	0.93 (15.79)	0.69	1.40
(3) X_1	0.07 (3.35)	$-0.41\ Y_1$ (-3.50)	$-0.32\ Z_1$ (-2.63)	0.71 (5.19)	0.71	1.91

REAL REGRESSION RESULTS, 1961–85

Dependent Variable	Constant	Investment	Deficit	Rho	R^2 (Adjusted)	D.W.
(4) X_2	0.04 (1.44)	$-0.21\ Y_2$ (-1.55)	$-0.20\ Z_2$ (-2.05)	0.63 (4.99)	0.52	1.76
(5) X_3	0.004 (0.15)	$-0.02\ Y_2$ (-0.15)	$-0.05\ Z_3$ (-0.52)	0.68 (4.75)	0.45	1.70
(6) X_4	0.03 (0.75)	$-0.16\ Y_2$ (-0.75)	$-0.02\ Z_3$ (-0.20)	OLS	-0.06	2.03
(7) X_5	-0.09 (-1.61)	$0.56\ Y_2$ (1.65)	$-0.10\ Z_3$ (-0.53)	OLS	0.08	1.89

NOTE: The ratios are in parentheses. For a one-tail test, t ratios more than 1.72 are significant at the 5 percent level.

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TABLE 4

NOMINAL REGRESSION RESULTS, 1954–80

Dependent Variable	Constant	Investment	Deficit	Rho	R^2 (Adjusted)	D.W.
(8) X_1	0.04 (3.68)	$-0.23\ Y_1$ (−3.37)	$-0.16\ Z_1$ (−2.42)	OLS	0.30	1.43
(9) X_1	0.05 (2.52)	$-0.34\ Y_1$ (−3.11)	$-0.27\ Z_1$ (−2.44)	0.90 (13.62)	0.81	1.91

REAL REGRESSION RESULTS, 1954–87

Dependent Variable	Constant	Investment	Deficit	Rho	R^2 (Adjusted)	D.W.
(10) X_2	0.02 (1.28)	$-0.15\ Y_2$ (−1.46)	$-0.22\ Z_2$ (−2.76)	0.67 (5.32)	0.64	1.90
(11) X_3	0.001 (0.07)	$-0.002\ Y_2$ (−0.01)	$-0.12\ Z_3$ (−1.61)	0.57 (4.09)	0.44	1.90
(12) X_4	0.03 (1.07)	$-0.18\ Y_2$ (−1.04)	$-0.02\ Z_3$ (−0.21)	OLS	−0.03	1.92
(13) X_5	−0.08 (−1.61)	$0.49\ Y_2$ (1.89)	$-0.14\ Z_3$ (−1.05)	OLS	0.08	1.88

NOTE: The ratios are in parentheses. For a one-tail test, t ratios more than 1.70 are statistically significant at the 5 percent level.

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Finally and most importantly, estimates of the twin-deficit relation with assets valued to market and adjusted for inflation are reported in equations (5)–(7) in Table 3 and equations (11)–(13) in Table 4. In none of these equations is the coefficient of either investment or the budget deficit significant. There are certainly econometric issues that can be raised regarding the way current-account deficits and budget deficits have been related to one another in the empirical literature. Nevertheless, in the genre of this literature, these results have identified no significant relation between the twin deficits when the variables are expressed in inflation-adjusted market-value terms.

Conclusion

The empirical results reported in this paper show no systematic association between the current-account and budget balances when both are adjusted for inflation and expressed in market-value terms—the adjustments that are relevant for evaluating whether the apparent twin-deficit relation is real or illusory. Using the data adjusted for both inflation and market-value changes, we found no significant link between fiscal and current-account balances during 1954–87.

Part of the apparent relation between the U.S. nominal budget and current-account deficits, which has received so much attention in recent years, is simply the result of money illusion: The nominal figures do not account for the effects of U.S. inflation on either the budget balance or the change in the U.S. NEW position. Another part is the result of an accounting illusion: The official measures of the budget and current-account balances do not account for the changed market values of the net U.S. federal debt or major elements of the U.S. NEW position.

These findings in no way show that either budget or current-account deficits are unimportant or unexplainable. Rather, our results indicate that the simplistic coupling of a budget deficit with a current-account deficit does not hold up in terms of inflation-adjusted market values of these measures.

Appendix A: Data Series

This Appendix contains the data on the changes in the real U.S. Net International Investment Position (NIIP) and in the various market-valued estimates of U.S. net external wealth (NEW), together with the budget-balance data (divided by real U.S. gross domestic product) used in the regression analysis conducted by the authors.

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TABLE A 1

REAL CURRENT-ACCOUNT AND FEDERAL-BUDGET BALANCES RELATIVE TO GDP (PERCENT)

	Change in				
	Real NIIP	Real Stock-Price NEW	Real Earnings NEW	Real Deflators NEW	Budget Balance
1951	0.01	0.21	1.63	0.19	—
1952	0.15	−0.17	0.52	0.002	—
1953	−0.02	0.06	−0.13	−0.02	—
1954	−0.28	0.23	0.48	−0.27	−1.38
1955	−0.25	0.38	0.80	−0.21	3.86
1956	0.41	0.25	1.72	0.57	4.48
1957	1.08	1.13	1.46	1.22	−0.15
1958	−0.28	−0.64	−1.50	−0.20	−0.74
1959	−0.43	1.76	0.47	−0.38	0.83
1960	0.26	1.59	1.45	0.42	−1.37
1961	0.38	0.96	1.60	0.40	−0.18
1962	0.77	−0.08	1.79	0.81	−0.88
1963	0.39	0.57	1.23	0.68	0.70
1964	0.85	0.76	0.78	0.74	−0.03
1965	0.64	−0.14	0.74	0.92	1.17
1966	0.21	−0.35	−1.83	0.73	0.78
1967	−0.07	0.85	−0.46	−0.06	−0.29
1968	−0.25	1.84	0.77	−0.15	1.54
1969	−0.19	0.29	1.31	0.10	2.66
1970	−1.25	−2.86	−1.82	−0.62	−1.53
1971	−1.42	−0.68	−1.06	−0.53	−1.17
1972	−0.92	1.67	1.13	−0.11	0.03
1973	0.57	−0.73	5.85	2.69	1.63
1974	0.34	−2.54	−2.92	1.50	1.90
1975	0.81	1.42	−5.15	1.00	−3.46
1976	0.30	−0.92	−0.22	0.41	−2.46
1977	−0.86	−0.04	−0.69	−0.06	0.34
1978	−0.18	0.92	0.23	0.59	2.00
1979	0.48	1.53	2.01	1.36	1.20
1980	0.14	0.24	−1.60	0.87	−0.21
1981	0.89	−0.72	0.38	−0.45	−0.90
1982	−0.17	−1.18	−0.67	−0.65	−6.56
1983	−1.53	−0.34	−1.43	−2.50	−3.16
1984	−2.40	−2.88	−2.39	−3.48	−4.57
1985	−2.94	0.40	1.95	−2.01	−6.44
1986	−3.84	0.10	−1.23	−2.68	−5.75
1987	−2.26	−0.37	2.71	−0.09	−0.01

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TABLE A 2

REAL U.S. NIIP AND STOCK-PRICE-BASED U.S. NEW
(BILLIONS OF 1982 DOLLARS)

	NIIP	Original Stock-Price NEW	Revised Stock-Price NEW
1970	117.9	199.3	194.1
1971	83.1	182.9	186.9
1972	59.3	226.0	232.6
1973	74.7	206.2	225.3
1974	83.9	137.7	159.2
1975	105.5	175.6	185.4
1976	113.9	150.0	154.6
1977	88.7	148.8	159.8
1978	83.2	177.3	203.2
1979	98.1	225.1	249.9
1980	102.7	244.7	257.4
1981	131.0	245.2	234.4
1982	125.7	229.3	197.7
1983	75.9	239.9	186.6
1984	−7.2	155.7	87.5
1985	−112.4	174.1	101.6
1986	−254.8	161.4	105.5
1987	−334.8	83.2	91.2

NOTE: The revised data on this page replace the stock-price-adjusted net-foreign-asset data found in Ulan and Dewald (1989, p. 383). The authors' original estimates were made under the assumption that the Department of Commerce's official figures included exchange-rate adjustment of the book values of U.S. direct investment abroad. In fact, Commerce makes no adjustments to the book values of either U.S. direct investment abroad or foreign direct investment here in the U.S. NIIP. As shown, the differences between the original and corrected series have at times been fairly substantial in absolute value but very small in the context of a national tangible wealth of about $15 trillion.

Compared to the original series, the revised stock-price-based NEW estimates are somewhat higher in the 1970s and lower in the 1980s. Nevertheless, over the whole period, both the original and revised estimates are much higher than the real official NIIP, the main finding in the authors' earlier work.

Appendix B: Data Sources

The data used in this study were those pertaining to the following:

- U.S. assets abroad and foreign assets in the United States found in *Historical Statistics of the United States: Colonial Times to*

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1970; Survey of Current Business (August 1984); and Scholl (1986, 1987, 1988).

- Nominal U.S. current account balances and earnings/price ratios found in the 1988 and 1989 *Economic Report of the President and Annual Report of the Council of Economic Advisers.*
- Book value of U.S. direct investment abroad by country since 1950, found in U.S. Department of Commerce, Bureau of Economic Analysis (1982, 1986); *Survey of Current Business* (August 1986); Scholl (1987); and Bach (1988).
- Price indices for stocks traded on the New York Stock Exchange and major stock exchanges in other industrial countries for which country-specific data on U.S. direct investment are found in the publications cited above, taken from *International Financial Statistics* data tapes 11 and 31 March and 13 May 1988, and the August 1988 *International Financial Statistics.*
- Year-end exchange rates for the dollar taken from *International Financial Statistics* data tapes, 31 January 1989.
- Data on government capital stock found in *Survey of Current Business* (October 1989).
- Deflator for fixed reproducible tangible wealth derived on the basis of data found in *Survey of Current Business* (October 1989).
- Earnings on foreign direct investment found in *Survey of Current Business* (March 1953, p. 8; June 1956, p. 24; June 1960, p. 14; June 1961, p. 12; and June 1988, pp. 40–41). Since data for years prior to 1960 refer to repatriated earnings only, for prior years, reinvested earnings found in U.S. Department of Commerce, Bureau of Economic Analysis (1982, pp. 55–64; 1984, p. 8), were added to the *Survey of Current Business* earnings data.
- Book values of foreign direct investment in the United States found in U.S. Department of Commerce, Bureau of Economic Analysis (1984, pp. 2–3), and Scholl (1988, p. 78).
- Year-end stocks of residential structures and nonresidential plant and equipment at current cost, taken from the April 1989 *Balance Sheets for the U.S. Economy 1949–88*, published by the Board of Governors of the Federal Reserve System.
- Nominal and real reproducible tangible wealth in the United States, found in *Survey of Current Business* (October 1989).
- Data on investment-deflator adjusted values of U.S. investment abroad and foreign investment in the United States taken from Eisner and Pieper (1988).

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- Government asset figures taken from Eisner (1986); updated and revised data relating to federal financial assets and liabilities furnished to the authors by Paul Pieper; and updated and revised data relating to federal, state, and local inventories furnished to the authors by John C. Musgrave.
- U.S. gold holdings prior to 1970 found in *Historical Statistics of the United States Colonial Times to 1970.*
- U.S. GNP and GDP real and nominal with deflators, gross private domestic investment, real and nominal, and NIPA federal budget deficits taken from Data Resources Inc., U.S. Central databank, 4 May 1989.
- Data on year-end gross federal debt held by the public furnished by Congressional Budget Office. The data are interpolations of CBO end-of-fiscal-year data.
- Data used by Noriel Roubini furnished by that author on diskette.

Requests for the data should include a high-density diskette and return mailer sent to the authors at the following address: EB/PAS, Room 3425, U.S. Department of State, Washington, DC 20520.

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A Public Choice Perspective on the Cycle in Monetary Policy

Thomas Havrilesky

> Perhaps the most important issue regarding inflation is why policy authorities have behaved, over the last 40 years, in a manner that permitted a many-fold increase in the price level in most industrial nations. A full answer to that question will require a much better theory of the political process than is currently available.
>
> —Bennett T. McCallum (1990, p. 1007)

Introduction

The purpose of this paper is to develop a theory of the cycle in monetary policy and, thereby, to suggest a direction for those who would seek an answer to Bennett McCallum's question. In this cycle, monetary policy oscillates between inflationary and disinflationary phases. The amplitude and periodicity of the cycle are determined by the cost to interest groups of organizing to sustain sound monetary policy. The theory is developed from the perspective of a public choice view of monetary policy.

A Public Choice Perspective

Monetary Policy

In the past decade and a half, there have been notable attempts to link monetary policy with political phenomena. The most popular of these was the theory of the political business cycle—both the original (Nordhaus 1975 and MacRae 1977) and the modern (Alesina and Sachs 1988) versions—that related monetary policy actions to the proximity of elections. In contrast, public choice theories of monetary policy purport to explain the behavior of the money supply across a

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The author is Professor of Economics at Duke University.

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wider variety of political conditions. These theories do not depend on the proximity or even the existence of free elections.

There are two types of public choice theory of monetary policy: One focuses on the Federal Reserve's bureaucratic self-interest (Toma 1982); the other focuses on the redistributive impact of monetary policy. In the latter category there are, again, two types of research: One type centers on the revenue generated for government by inflation; the other focuses on the use of moentary policy to redistribute income between sectors. While they seldom use the label "public choice," there are a number of proponents of the latter approach, for example, Streissler (1976), Wagner (1986), Havrilesky (1987), and Hetzel (1990). These researchers share the general view that monetary policy actions are driven by rent-seeking interest groups and politicians who respond to organized sectoral pressures.[1]

This type of public choice theory of monetary policy is motivated by two fundamental observations. First, rather than converging on a time-consistent path, money growth is highly erratic, largely because it responds to pressures from the executive (Havrilesky 1988) and legislative branches (Grier 1989) and from private interest groups (Havrilesky 1990). Second, promises to redistribute income not only dominate formal election campaigns, they are the bread and butter of politicians in practically all economies at virtually all times.

This approach to monetary policy is consistent with modern rational expectations reasoning. No matter how forward-looking voters are, they will be imperfectly informed about future environments. Therefore, voters can anticipate neither the timing nor the magnitude of related monetary surprises; neither can they easily filter credible signals for surprises from the often subtle, but continual, barrage of political and private pressures on monetary policymakers.

Finally, this theory of monetary policy is compatible with a wide array of political arrangements. Redistributive promises, from the

[1]One particular variation on this general theme is that monetary policy is used to counteract the adverse consequences of the sectoral burdens imposed by politicians' redistributive agendas. The money supply's response to the sectoral flak generated by changes in interest rates, exchange rates, and output is a by-product of politically optimal redistributive programs. The particulars of each promised redistribution—the groups favored, the variables and sectors subsequently affected, and the related monetary surprises–depend on the distribution of voting rights within the distribution of income, as well as on existing financial regulatory and tax structures. For example, a rapid expansion in voting rights relative to the distribution of earned income can usually be expected to ignite such a formidable redistribution that its sectoral impacts will precipitate a monetary surprise. Since these (income and voting rights) distributions and structures change over time, the promised redistributions, the sectors and variables subsequently burdened by the redistributions, and the related monetary surprises will also change over time (Havrilesky 1987 and 1988).

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bread and circuses of ancient times to Reagan's supply-side tax cuts, seem to have consistently provoked monetary surprises, from the ancient sovereign's debasing the coinage to the Reagan administration's outburst of monetary growth in 1985–86. The prospects for further historical testing of this type of public choice theory of monetary policy are inviting.

Monetary Reform

The public choice view is that unstable money growth patterns and, in the present paper, the cycle in monetary policy emerge because permanent restraint on government attempts to redistribute income is a public good. Fundamental reform of fiscal and monetary institutions is ordinarily not feasible. Fiscal reforms, such as those trying new spending or tax cut programs to offsetting tax increases or program cutbacks, are ordinarily unacceptable to politicians because they would result in overt distributive conflict. Monetary reforms that would uncouple money supply growth from interest group pressures (for example, by returning to the gold standard) are similarly unpalatable, because by denying politicians the monetary camouflage, they, too, would bring distributive conflict out into the open. Open distributive confrontation in legislatures or in the streets would typically prove quite costly.[2] Given the immediate benefits to rent-seeking interest groups and politicans and given the diffuse and often remote shared costs of continuing activist fiscal and monetary

[2]There are, of course, social scientists who would contend that distributive conflict can be reduced by the appropriate economic policies. For example, many embrace the ideal that carefully conceived policies to engineer a growing economic pie can reduce, if not eliminate, conflict over its distribution. Others, of a more philosophical bent, promote visionary principles of social justice, claiming that a just income distribution could forestall conflict.

Counterposed to humanist views is the ancient wisdom that conflict is an unavoidable consequence of private greed. The great communal religious traditions hold that individual attachment to wealth, like the attachment to anything outside oneself such as fame and power, is ultimately anterior to conflict. Spiritual teachings say that the attachment to private wealth cannot be a source of happiness, the wealth conveys a special status to its possessor, and that such specialness leads to conflict. If the conflicted wealthy need to find scapegoats for their unhappiness, what more convenient scapegoats are there than those who mimic their own materialistic values? Thus, society's "haves" are wont to fear its "have nots" and to charge them with greed and corruption. In this manner, fear and hate of others may become a direct reflection of self-hate. Spiritual teachings say that whatever individuals project for their brother they believe for themselves. In short, spiritual teachings hold that as long as one seeks outside oneself, there can be only conflict within oneself and with one's brothers and sisters. It follows that social stability, of which monetary stability is a part, cannot be found without a change in consciousness. To put it succinctly, the ethos of consumerism, unfettered by social compassion, has its limitations, as it can only increase the domain of unresolved distributive conflict (Havrilesky 1989a).

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arrangements, it is difficult to envision the emergence of cohesive political coalitions that would promote reform. Devotees of fiscal and monetary reform have every reason to subside into a state of resigned pessimism.

The Cycle in Monetary Policy

Short-Run Benefits of Increasing Inflation

Since reforms that would more or less permanently restrain the monetary policy consequences of political rent-seeking have not been forthcoming, inflation rates tend to be highly erratic. The rates typically oscillate between long periods during which they rather steadily rise and shorter periods during which they are low and stable. During the former intervals there are formidable short-run benefits from rising inflation, associated with its potential for surprising market participants. Unfortunately, surprise increases in the rate of inflation of a given magnitude will swiftly lose their ability to affect output, employment, real interest rates, and real exchange rates. After a given level of inflation persists over time, market participants adapt and make appropriate adjustments in nominal wages, output prices, and asset prices. This erosion of benefits induces policymakers to further increase the money growth rate, but, once again, market participants catch on to the resulting higher inflation rate and benefits wane.

From the singular perspective of these short-lived benefits, surprise increases in money growth would continue unbounded. However, as market participants grow accustomed to increasing inflation, surprises have to become larger and larger in order to obtain the same short-lived flow of benefits.[3] Inasmuch as desired effects can be achieved only if the policymaker allows larger and larger doses of inflation, the process resembles a physical addiction.[4]

[3]The persistence of short-lived benefits from inflationary surprises is consistent with forward-looking agent behavior if there is imperfect information regarding the timing and magnitude of policymaker responses to the flood of private and public pressures on monetary policy. In economies where the financial regulatory and tax structures, as well as the composition of output and income, are changing over time, forward-looking agents can anticipate neither the location, the magnitude and timing of sectoral pressures on monetary policy, nor the timing and magnitude of the related policymaker responses.

[4]Addictive processes typically feature benefit flows and stock costs (in the form of a rate of deterioration [depreciation] of a stock). There are two approaches to addiction in the legal literature, the strong substance caused view (SSCV) and the characterological view (CV). In the former, withdrawal costs rise with use because the substance itself is addictive; in the latter, this rise does not necessarily occur because withdrawal costs are endemic in the user's character (Schwartz 1989). The parallel to the SSCV in

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Long-Run Costs

The resemblance to a physical addiction does not end with the increasing inflation phase of the cycle. As with a physical addiction, there are adverse effects on health; in this case, "health" is measured by the stock of aggregate wealth. As the rate of inflation rises, economic growth is impeded and the stock of wealth depreciates more rapidly. The descriptive literature on inflation provides a host of reasons for the positive relationship between the rate of inflation and the rate of deterioration of aggregate wealth. As inflation rises, more resources are allocated to hedging and speculation; more resources are allocated by creditors to hasten and by debtors to retard debt collection; capital inputs in the form of real money balances are held at lower levels; and, finally, because nominal price changes are not synchronized, relative price distortions and uncertainty increase. In addition, if interest expenses are deductible for income tax purposes, real saving declines and debt/equity ratios rise, thereby increasing default risk and reducing capital formation. All this reduces economic growth.[5] While output growth is declining, rising inflation is boosting interest rates and increasing the velocity of money. As the growth of output declines and the velocity of money rises, any given increase in money growth will be more and more inflationary.[6]

When and how will increases in the rate of inflation end? Since the control of inflation is a government responsibility, its reduction requires that private citizens organize and/or enlist the support of existing interest groups. The height to which inflation must rise before interest groups coalesce to reduce and stabilize it depends critically on organization costs. Credible anti-inflationary policies will commence only when the marginal costs of inflation exceed the marginal costs of organizing.

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monetary addiction occurs in prerational expectations Keynesian models where the greater the inflation, the greater the subsequent recessionary cost of withdrawal (see footnote 5). The CV is consistent with the view presented here, namely the withdrawal costs depend on the system's organizational "character." (See Becker and Murphy 1988.)

[5]Besides the reduction in economic growth, there are other costs. For example, in prerational expectations Keynesian models, as inflation increases, the costs associated with a likely recession rise. Finally, if experiments with price controls are attempted during this phase of the cycle, as they often are, all of the preceding problems causing deterioration of the stock of the economy's wealth are exacerbated. This laundry list of inflationary "bads" ignores any long-run benefits from inflation, such as possible increases in government revenues arising from an inflation tax on monetary balances.

[6]This sequence can lead to hyperinflation as described, for example, in Cagan (1956) and Sargent and Wallace (1973).

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In economies where interest groups traditionally struggle with one another and with government over the distribution of income, such as certain Latin American countries, there is strong interest-group disaggregation. Also, in these economies there is seldom a permanent anti-inflationary institution in the form of an autonomous central bank. For each of these reasons the costs of organizing to bring about anti-inflationary restraint will be formidable. To the extent that groups find it difficult to rally behind the monetary authority, the credibility of official anti-inflationary pronouncements will be low (Fellner 1979). In economies where sectoral strife is the norm, inflation is typically not attacked until political change occurs and a strong leader or external authority intervenes to restrain warring groups. In these economies, inflation usually must rise to very high levels before a policy of monetary restraint can be effected.

In economies, such as Japan and Switzerland, where overt sectoral strife is not customary and/or where political and moral leadership can quickly mitigate it, organizational costs are relatively low. These economies usually display minimal polarization among interest groups. They typically exhibit significant restraints on political rent-seeking and a deeply imbedded traditional opposition to overt distributive conflict. These economies also tend to have relatively autonomous central banks, which typically are the rallying point for anti-inflationary sentiment. In these economies, inflation is seldom permitted to rise to double-digit levels before effective demands are made for monetary policy restraint.

Monetary Restraint

Inflation increases over time until it reaches a critical level where ever-rising, collectively shared costs and zero long-run benefits force interest groups to coalesce and to demand the implementation of monetary restraint. As indicated earlier, the amplitude of the cycle, exactly how far the inflation must rise before a stabilization crisis occurs and before sound monetary policy is implemented, depends on organization costs. Traditional cleavages among interest groups and lower degrees of central bank autonomy raise the costs of organizing an effective anti-inflation coalition. Nevertheless, as inflation rises, interest groups are forced to become more cooperative in order to avoid mutual disaster. Modern game theorists support the notion that the greater the loss to be avoided through cooperation, the more cooperation is observed; that is, the supply curve of cooperation is upward sloping (Dawes and Thaler 1988).

After interest groups organize, the end to inflation is usually abrupt. Often there will be dramatic signals that precipitate the shift, such

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as rapid reserve outflows or currency depreciation combined with pressure from external authorities. Once consensus has been established to forego further benefits from increases in inflation, the optimal policy is to restore economic health as quickly as credible targets can be agreed upon. The monetary authority typically takes quick advantage of supportive anti-inflationary coalitions and the resulting credibility of market participants to effect a low-cost return to monetary stability. Therefore, at this stage of the cycle, gradualism is usually not observed.[7]

The ensuing interval of monetary restraint is often fraught with (discussion of) programs to increase capital formation and to reduce the more extravagant forms of collective consumption. Unfortunately, this phase in the monetary policy cycle is not permanent. Export-oriented and import-competing industries increase their lobbying for protection (Bernholz 1987). As memories of the inflationary phase fade, these and other interest groups increasingly lament foregone rent-seeking opportunities, and sound money cohesiveness will weaken.[8] Demands for monetary relief from intermittent swings in interest rates, exchange rates, output, and unemployment will grow. Constraints on the political manipulation of monetary policy and the limits of central bank autonomy will be tested. Given a sufficiently strong shock to key variables, the sound money barrier will be broken. With a return to monetary activism, the addictive process is resumed and inflation once again rises.

The Limits to Inflation

Thus, the amplitude and periodicity of the cycle in monetary policy depend critically on organization costs. The level of organization costs varies inversely with the degree of central bank autonomy and the strength of traditional restraints that limit political rent-seeking,

[7]Leland Yeager (1981), in his classic study on the termination of inflations, shows that the ends of great inflations almost invariably are sudden, supported by temporary coalitions of interest groups who find a strong executive or outside authority to lead the effort and to emanate credible resolve. John Taylor (1983) shows that even in an overlapping-generations world with nominal contracting, the reduction in inflation can be costless if policy is credible.

[8]The growth of government and the related proliferation of interest groups have often led analysts to suggest a (strengthening of) corporatist imposition of order on distributive struggles by government authority. Corporatist schemes do not always succeed. In economies where authority is not too diffuse and ruling elites traditionally use government power to reduce threats from below through cooptation, corporatist ventures such as incomes policies seem to work. In economies where interest groups are not well organized, are not hierarchically structured, are competitive with one another, and are fraught with internal partisan subdivisions, corporatist schemes are less successful (Goldthorpe 1984).

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enjoin against group distributive conflict, and encourage cooperation out of mutual concern for monetary disorder.

Modern game theorists contend that traditions of cooperation and mutual assistance convert uncooperative games (such as influencing monetary policy in order to extract rents) into the equivalent of team play. At the micro level, reciprocity, cooperation, and mutual assistance increase with the expectation of repeated future interaction. The closer the sense of community among individuals, the greater the frequency and intensity of interaction. This suggests that economies that systematically invest resources in building a sense of community may reap the benefits of monetary stability. Such investments can increase the level of social compassion, reduce the domain of unresolved distributive conflict, and, ultimately, constrain inflation.[9] Inflation might virtually cease to be a problem in an economy where the distribution of income was consensually considered fair and just.

The limits to inflation are determined by traditions that restrain rent-seeking and conflict and that encourage central bank autonomy. In economies where these traditions are minimal, only a hyperinflation can bring about monetary restraint, and the resulting interval of sound monetary policy will be short lived. In contrast, in economies where these traditions are formidable, even double-digit inflation will be intolerable and sound money intervals will be more durable.[10] These traditions thrive where there is a strong sense of community. Thus, the limits to inflation are ultimately determined by the allocation of resources toward building a sense of community and expanding social compassion.

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[9]As a stronger sense of community develops, values shift away from materialism and demeaning others toward acceptance and love—the free market laced with altriuism. To the extent that this shift happens, there is less distributive conflict and there are fewer opportunities for political gain through redistributive fiscal and monetary policy.

[10]The bimodal distribution of economies into high-inflation or low-inflation groups may be a useful starting point for testing the theory. All things being equal, low-inflation economies should exhibit less distributive conflict and more altruism. Of course, there may be threshold effects, whereby in economies with low levels of altruism, marginal increases in altruism may initially constrain punishment strategies more than they reinforce cooperation. For these economies, increases in altruism will not reduce inflation until this threshold is passed (Bernheim and Stark 1988).

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COMMUNICATIONS

PRICE-LEVEL STABILITY, PRICE FLEXIBILITY, AND FISHER'S BUSINESS CYCLE MODEL

Scott Sumner

Introduction

In a series of recent papers, De Long and Summers (1986, 1988) argued that "increased wage and price flexibility can easily be destabilizing because of the Mundell effect." They also suggested that early studies of the Phillips Curve by Irving Fisher (1923, 1925) had reached a similar conclusion. The National Industrial Recovery Act of 1933 (NIRA) was cited as a possible example of how policies designed to reduce price flexibility could have a stabilizing effect on output.

One motivation for this paper is to show that De Long and Summers appear to have misunderstood both the implications of Fisher's business cycle model and the impact of the NIRA on the level of U.S. output. De Long and Summers have apparently confused the concept of price-level instability (i.e., erratic fluctuations in the price level) with price flexibility (the absence of constraints separating the actual price level from its Walrasian equilibrium value). Although Fisher believed that price-level *instability* was the primary cause of output fluctuations, he would not have agreed with the proposition that a reduction in price *flexibility* is stabilizing.

A second purpose of this paper is to see how Fisher's model performs in the 10 years following its original publication. Fisher (1925) developed a model in which a distributed lag of inflation rates was used to explain deviations of output from the trend during 1915–22. It will be shown that Fisher's "Phillips Curve" model continues to perform reasonably well at explaining output fluctuations until July 1933. After July 1933, output falls sharply below the level predicted

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The author is Associate Professor of Economics at Bentley College.

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by Fisher's model. This structural break is associated with the implementation of the NIRA. The poor performance of Fisher's model after July 1933 may help explain why the monetary approach to business cycles, which was dominant during the 1920s, was virtually abandoned after the mid-1930s.

Fisher's Model of the Business Cycle

Fisher saw the business cycle as largely a "dance of the dollar." He differed from most modern researchers, however, by his assumption that the causality ran strictly from prices to output.[1] In his model, price fluctuations affected output because "When producers get higher prices, they do not at first have to pay higher wages and salaries" (Fisher 1925, p. 180). Another difference between Fisher's model and more recent models featuring sticky wages is that Fisher did not assume rational (or even adaptive) expectations.[2] During the early 1930s, Fisher began to stress the impact of deflation on debt burdens as an important factor in the rise in bankruptcies and unemployment.

Figure 1 is reprinted from Fisher's 1925 paper. It shows trend-adjusted output (T) and a distributed lag of inflation rates ($\overline{P}'$) extending over 114 months. The reported correlation is .941. (See the Appendix for a detailed description of Figures 1 and 2.) Using a similar technique, Fisher found somewhat lower price-output correlations during earlier periods of U.S. history.

Although Fisher was the first economist to provide a mathematical representation of the Phillips Curve, the idea of a short-run tradeoff between inflation and output was an essential part of macroeconomic theory during the 1920s. A number of contemporary economists, including Keynes (1923), Cassel (1922), Pigou (1927), Hawtrey (1923), and Robertson (1922), saw price instability as a major cause of the business cycle.[3] This view led many of these economists to recommend that monetary policy be directed toward the goal of

[1]Fisher (1925, p. 186) rejects the idea of estimating the correlation between changes in current output and future inflation on the grounds that this "would involve the apparent absurdity of bringing some of the effects earlier than their supposed cause."

[2]Fisher was familiar with adaptive expectations, having used this concept in his work on nominal interest rates. The fact that Fisher's model performed as well as it did during the interwar years may be due to the fact that the expected rate of inflation was probably close to zero under the gold standard.

[3]Pigou (1927) estimated that approximately one-half of the output variability was caused by price-level fluctuations.

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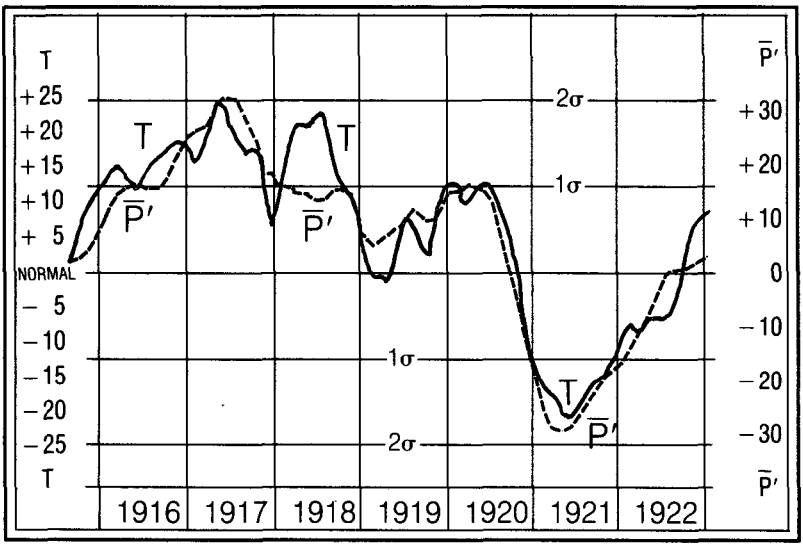
FIGURE 1

TREND-ADJUSTED OUTPUT AND DISTRIBUTED LAG OF INFLATION RATES OVER 114 MONTHS



NOTE: T represents the volume of trade or the trend-adjusted output; $\bar{P}'$ represents a distributed lag of monthly inflation rates.

SOURCE: Fisher (1925, p. 188).

price-level stabilization.[4] Wage and price controls were not regarded as an effective substitute for monetary stability.

After the mid-1930s there was a sharp decline in interest in proposals to stabilize the price level. To see why the neoclassical macroeconomics of the 1920s was eclipsed by Keynesian economics, one might find it helpful to see how well Fisher's model explained output fluctuations in the period leading up to the 1936 publication of the *General Theory*.

Figure 2 shows the result of updating Fisher's model to the 1923–35 period. The correlation between the predicted and the actual output series was only .256. This low correlation, however, is somewhat misleading since, during the decade from January 1923 through July 1933, the correlation was .851. The variability of output

[4]Both Hawtrey and Cassel proposed the use of central bank cooperation under a gold exchange standard. Keynes and Wicksell preferred a completely managed fiat currency. Fisher's "Compensated Dollar Plan" would have adjusted the price of gold inversely to changes in the price level.

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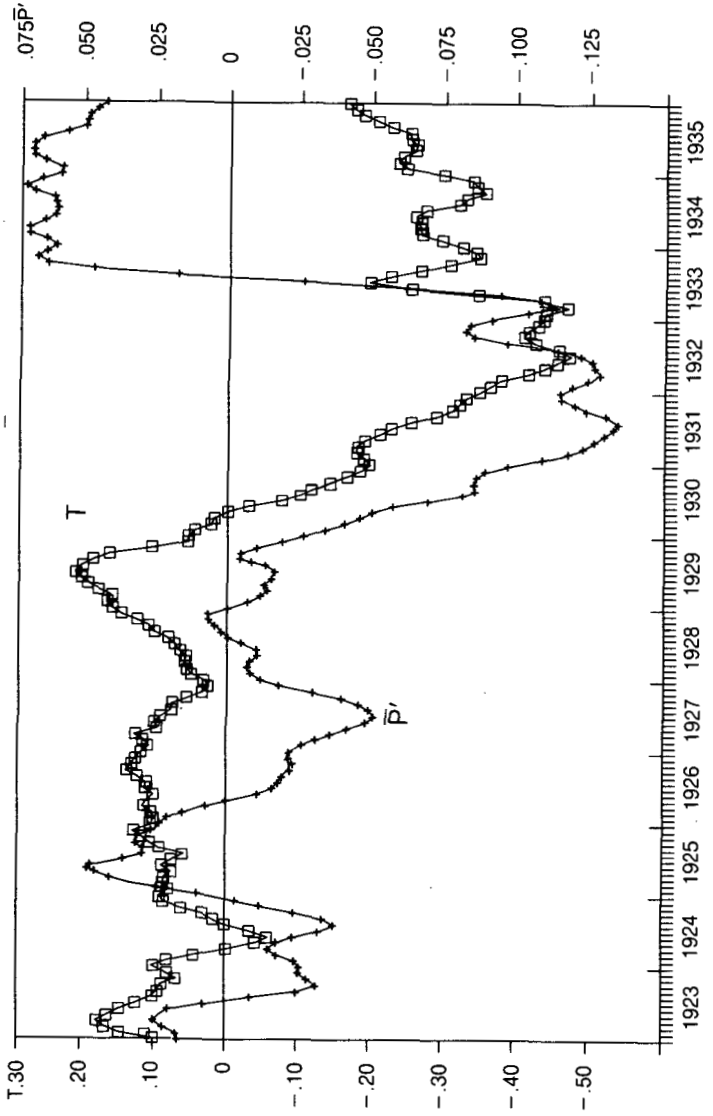
FIGURE 2

DEVIATIONS OF INDUSTRIAL PRODUCTION FROM TREND (T) AND DISTRIBUTED LAG OF MONTHLY INFLATION RATES ($\bar{P}'$), 1923–35



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in that decade was somewhat higher relative to the variability of inflation than was the case during 1915–22, but the qualitative similarities between the two periods would suggest no apparent reason for rejecting Fisher's model.

The model also predicts a rapid recovery from the depression during 1933. Industrial production did rise by almost 50 percent during the first half of 1933—a much sharper rebound than occurred during the early stages of recovery from the 1920–22 depression. After July 1933, however, the economic recovery stalled and industrial production did not return to its July levels until August 1935.

One of the more unusual aspects of the U.S. economy during 1933 was the rapid increase in the price level during a time when output was far below capacity. McCloskey and Zecher (1984) compared weekly changes in the foreign exchange value of the dollar with wholesale prices; they argued persuasively that the inflation that occurred during the spring of 1933 was caused by a depreciation in the dollar.

De Long and Summers suggest that the NIRA helped increase prices during 1933. If so, then its major impact could not have occurred before June or July. The NIRA was passed on June 16 and was first implemented on July 15. The impact of the NIRA codes shows up most clearly in the Bureau of Labor Statistics' aggregate wage series (see Table 1). Note that the aggregate wage rate rose 22 percent (19 percent in real terms) between July and September 1933. It seems clear that only governmental intervention in the labor market could have produced such a large increase in wages during a period of 25 percent unemployment.

This sharp increase in real wages was associated with a dramatic slowdown in industrial production. During the first half of 1933 industrial production had increased simultaneously with the price level. After the adoption of the NIRA codes, however, industrial production dropped sharply while prices continued to increase.

In retrospect, it is not surprising that De Long and Summers viewed Fisher as a supporter of New Deal attempts at reducing price flexibility. Fisher argued that, under most circumstances, monetary policy should aim at price-level stabilization. After the sharp deflation of 1929–33, Fisher felt that some degree of reflation was necessary before prices were stabilized. In fact, Fisher was an enthusiastic supporter of President Roosevelt's policy of reflation.

As previously noted, however, the primary cause of rising prices during 1933 appears to have been the devaluation of the dollar. Unlike wage-price controls, this action was not inconsistent with Fisher's free-market ideology. Thus, although in 1933 Fisher clearly

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TABLE 1

SELECTED ECONOMIC INDICATORS, MONTHLY, 1933

Month	Exchange Rate[a]	WPI[b]	Industrial Production[c]	Average Wages[d]
January	3.361	61.0	30.8	.406
February	3.422	59.8	30.7	.404
March	3.433	60.2	29.0	.405
April	3.579	60.4	31.0	.401
May	3.932	62.7	36.2	.398
June	4.136	65.0	41.6	.394
July	4.650	68.9	45.3	.399
August	4.503	69.5	43.5	.459
September	4.665	70.8	41.2	.488
October	4.668	71.2	38.9	.493
November	5.150	71.1	36.7	.496
December	5.116	70.8	37.0	.503

[a]Exchange Rate = Dollar Price of Pounds, from the *Federal Reserve Bulletin*.
[b]WPI = Wholesale Price Index as measured by the *Bureau of Labor Statistics*, (1926 = 100).
[c]Industrial Production is taken from the *Federal Reserve Bulletin*, (1947–49 = 100).
[d]Average Wages = Production-Worker Average Hourly Earnings (in dollars) from *Employment and Earnings*.

favored reflation and then price-level stabilization, he also argued that "the introduction of codes under the NRA, as well as the processing of taxes under the AAA, seemed to have a deterrent effect upon the activities of industry" (Fisher 1934, p. 362). Fisher favored price-level *stability* but not price *inflexibility*.

Fisher employed a quantity theoretic framework to analyze changes in the price level. While subsequent Keynesian theorists argued that monetary policy was ineffective during the Great Depression, Fisher believed that the 1929–33 deflation could have been averted by a more expansionary monetary policy. In fact, Fisher (1933, p. 347) believed that such a policy would have been adopted "had Governor Strong of the Federal Reserve Bank of New York lived, or had his policies been embraced by other banks and the Federal Reserve Board and pursued consistently after his death."

Fisher was also aware that the constraints imposed by the international gold standard could at times prevent the monetary authority from taking the steps necessary to stabilize the price level. He, there-

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fore, proposed a "Compensated Dollar Plan" whereby the value of the dollar would be adjusted each month in proportion to changes in the price level (i.e., the price of gold would be adjusted inversely with the price level). One of the reasons why Fisher was so supportive of Roosevelt's policies was that the devaluation of 1933 in a sense represented a belated implementation of the Compensated Dollar Plan.

Conclusion

The view that price-level instability is an important source of output fluctuations was a key element of pre-Keynesian macroeconomic theory. By using Fisher's Phillips Curve model to predict output fluctuations over the period from 1923 to 1935, we can gain insights into the events that led to the Keynesian revolution. Fisher's model provides no explanation for the relatively low level of production from mid-1933 to mid-1935. There is circumstantial evidence that the adoption of the NIRA in June 1933 helped abort a vigorous economic recovery that was already under way.[5]

Although it appears that De Long and Summers were incorrect in suggesting that the NIRA might have had a stabilizing impact, this fact should not be interpreted as a rejection of their model. They noted that on theoretical grounds the NIRA's effect was ambiguous and that "The NIRA's encouragement of cartelization may have had contractionary macroeconomic effects" (De Long and Summers 1986, p. 1043). Neither should the fact that the adoption of NIRA codes was associated with a pause in the recovery be construed as ruling out other contributing factors that may have delayed recovery, such as trade wars or bank panics.

In a subsequent paper, De Long and Summers (1988) argued that recovery occurred after the *announcement* of the NRA. As noted earlier, the weekly data examined by McCloskey and Zecher show a clear relationship between inflation and devaluation. With respect to wages (a nontraded good), the impact of the NIRA does not occur until after July.

De Long and Summers (1988) also stated that "In an accounting sense *all* of the Great Depression was due to a collapse in monetary velocity that cannot implausibly be traced to deflation; recall that real broad money balances (M2) did not decline between 1929 and 1932" (p. 275). It is true that all four components of the quantity equation declined by approximately one-third between 1929 and

[5]Weinstein (1980) reached a similar conclusion.

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1933. But if prices had been artificially restrained from declining after 1929, then, holding Federal Reserve policy constant, real money balances would have declined sharply.[6] Thus, their observation has no bearing on the stabilizing properties of price flexibility.

A more serious problem with their argument is that De Long and Summers seem to repeatedly confuse price flexibility with price instability. For instance, in the 1988 paper they cite evidence from earlier studies showing that price shocks affect future output movements. This finding is consistent with numerous conventional macro models, including new classical models where unperceived price-level changes affect output (with a lag caused by adjustment costs), as well as "Keynesian" models featuring the sort of wage rigidities described by Fischer (1977).[7]

Appendix

In his 1925 paper, Irving Fisher used a detrended, seasonally adjusted index of output (T) that was computed by Warren M. Persons. The Wholesale Price Index published by the Bureau of Labor Statistics was used to calculate the inflation rate. The monthly inflation rate was defined as the percentage change between the last period's price level and the next period's price level, multiplied by six. The distributed lag of inflation rates was derived by taking a weighted average of 114 lags of the inflation rate. The distribution of weights is approximately normal when the time axis is transformed logarithmically.

In updating Fisher's model to the 1923–35 period, I used the seasonally adjusted industrial production series computed by the Board of Governors of the Federal Reserve System. The output series shown in Figure 2 represents the percentage difference between actual industrial production and its predicted value derived by regressing monthly industrial production on time, over the 1913–46 period. Since the sample period ends in the middle of the Great Depression, the series was detrended over a period including several business cycles. I also attempted to use the same weights on lagged inflation as in Fisher's 1925 paper. However, as Fisher was somewhat vague regarding his methodology, there may be some slight differences.

[6]One could, of course, argue that had deflation not occurred, then the money multiplier, and therefore M2, would not have declined. This argument would not apply, however, to deflations accompanied by sharp drops in the monetary base, as occurred during 1920–21.

[7]Although Fischer's model is usually regarded as "Keynesian," it is clearly much closer to the pre-Keynesian models of Fisher and Pigou.

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Price-Level "Flexibility" and the Coming of the New Deal: Reply to Sumner

J. Bradford De Long and Lawrence H. Summers

Sumner's crtique of our *American Economic Review* papers (De Long and Summers 1986, 1988) raises issues on the levels of economic policy and of economic history. We first discuss issues relating to the proper conduct of economic policy, and conclude that Sumner's critique does not alter our view. We then turn to the issues concerning the appropriate interpretation of the Great Depression, and conclude that Sumner's critique of our analysis of the National Industrial Recovery Act of 1933 (NIRA) has some force. If we were writing our 1986 paper over again, we would place stress on the general abandonment by Roosevelt of the previous deflationary policy regime, on the devaluation of the dollar and the passing of the NIRA as twin signals of this shift in regime, and not on the NIRA itself as a unique signal of the end of deflation.

Economic Policy

Sumner attempts to draw a distinction between price-level *stability* and price-level *inflexibility*. We do not find this distinction compelling. If—as Irving Fisher thought and as we think—the key to avoiding deep depressions lies in maintaining enough price-level stability to keep the self-reinforcing spiral of deflation and depression from gathering force, then anything that tends to make the price level *inflexible*—in the sense of making it unresponsive to macroeconomic shocks—is likely to decrease the likelihood of deep depressions.

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J. Bradford De Long is Assistant Professor of Economics at Harvard University and a Faculty Research Fellow at the National Bureau of Economic Research. Lawrence H. Summers is Professor of Economics at Harvard and a Research Associate of the NBER.

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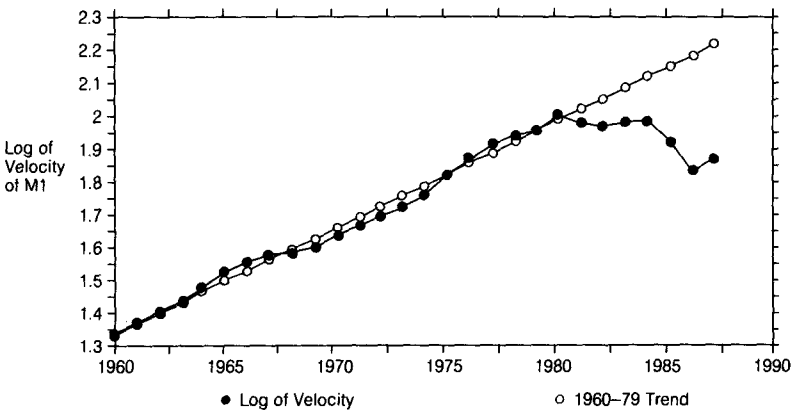
Price-level inflexibility could be generated by long-term labor contracts, by firms' desires to maintain consistent wage and salary schemes, by—as Sumner correctly notes Irving Fisher would have preferred—confidence that the central bank will move quickly to offset macroeconomic shocks, or by any of numerous other mechanisms. Different mechanisms will, of course, have different effects on the economy's *microeconomic* performance as it allocates scarce resources to alternative uses. But all mechanisms that create price-level inflexibility will decrease the likelihood of deep depressions as long as very large declines in real aggregate demand are driven not by large declines in the real money stock but by large declines in the velocity of money generated by households' perceptions of ongoing inflation.

Do these considerations have empirical as well as theoretical force? The only two major "natural experiments" that the United States has seen in the past century do suggest that changes in households' perceptions of the current ongoing rate of inflation or deflation have large effects on the velocity of money. One of these "experiments" was the Great Depression itself, during which the entire fall in real GNP could, in an accounting sense, be attributed to a decline in velocity; the Great Depression is the subject of the second half of this comment. The second more recent "experiment," considered here, is the similar collapse of monetary velocity during the Volcker depression of the early 1980s, as shown in Figure 1. William Poole (1988) has argued that such a decline in velocity is what one should have expected to see, given the decline in the rate of inflation (and

FIGURE 1

THE VELOCITY OF MONEY IN THE UNITED STATES, 1960–87



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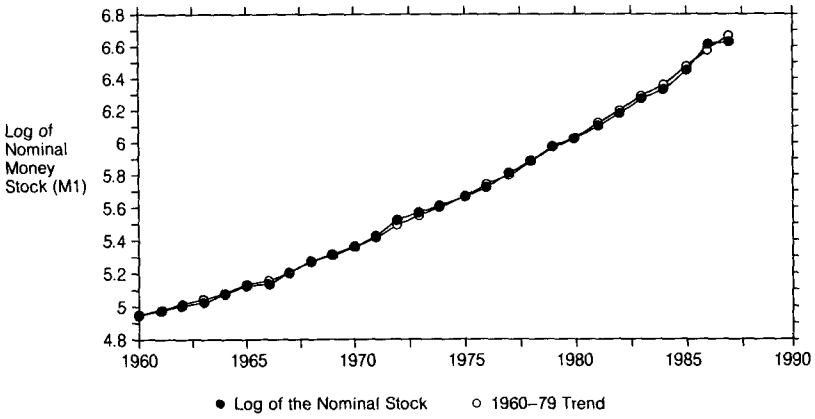
the concommitant decline in long-term interest rates) during the 1980s, and assuming that money demand is relatively sensitive to shifts in households' perceptions of the ongoing rate of inflation (or level of nominal interest rates).

Recognition of the key role played in deep depressions by collapses in velocity has implications for economic policy (in addition to the recognition that institutions which support price-level inflexibility may be useful) that Sumner fails to draw out. One kind of monetarism, which we associate with Irving Fisher and with Friedman and Schwartz's (1963) *Monetary History of the United States*, sees the key to monetary policy as the maintenance of a stable path for the price level and for the total level of nominal aggregate demand. Monetarism of a second kind, found in Friedman (1984b), for example, argues that the key to monetary policy is the maintenance of a stable path for a relatively restrictive monetary aggregate—in the case of Friedman (1984b), the nominal stock of high-powered money. Monetarism of the second kind shifts primacy from achieving a stable path for nominal demand and prices to achieving a stable path for some restrictive measure of the most liquid assets.

If the velocity of money really is, as we maintained in our *American Economic Review* articles, sensitive to perceptions of ongoing deflation, then policies recommended by this second tendency flirt with disaster. The Great Depression showed that a stable path for real balances or for the nominal stock of high-powered money was perfectly consistent with a deep deflation-driven depression. A similar lesson can be drawn from the Volcker depression. As Figure 2 shows,

FIGURE 2

GROWTH OF THE NOMINAL MONEY STOCK, 1960–87



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the path of growth of the nominal money supply did not slow much in the 1980s. This fact led monetarists of the second kind (see, for example, Friedman 1984a) to call for additional monetary contraction. To the extent that such contraction would have further reduced perceived inflation and reinforced the collapse of velocity, it would have been a bad mistake to follow such advice—advice given because, as Poole (1988) puts it, monetarists "analyzing monetary policy . . . relied on a velocity time trend" instead of an economic theory of velocity.

Economic History

As Figure 3 shows, the Great Depression was an economic collapse of a magnitude that had never before been seen. Previous depressions had come to an end—the equilibrium-restoring forces at work in a market economy had swung into action—when slack and idle resources were between 5 and 10 percent of GNP more than average. On the basis of pre-1929 experience, in every year from 1930 on, it would have been reasonable (given the past pattern of cyclical volatility) to expect that prosperity was just around the corner. Yet the slide into the Great Depression went on and on, piling up more and more unused resources, until the inauguration of Roosevelt and the coming of the New Deal.

As Figure 4 shows, the slide into the Great Depression was not accounted for by declines in the money stock or in high-powered money: Both the velocity of money and the product of velocity and the money multiplier fell steeply during the Depression. Monetary policy was "expansionary" in the sense that the central bank kept both the real money stock and the nominal high-powered money stock approximately constant and kept nominal interest rates on government obligations low during the slide.

We see Roosevelt's announcement of a New Deal as the key factor that removed expectations of further deflation and so allowed the beginnings of recovery. We saw the NIRA as the centerpiece of the first stage of the New Deal, and attributed to it the shift in perceptions—the recognition that Roosevelt's inauguration marked a sharp break from the previous deflationary policy regime, and that henceforth deflation was not to be feared—that we see as the principal factor driving the recovery that began in 1933. We argued that the damaging *microeconomic* effects the National Recovery Act (NRA) may well have had on the economy's performance as a resource allocation mechanism would have been swamped, in the first stage at least, by the *macroeconomic* effects of the shift in expectations generated by the passage of the NIRA as a signal that the

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FIGURE 3

THE U.S. BUSINESS CYCLE, 1890–1940

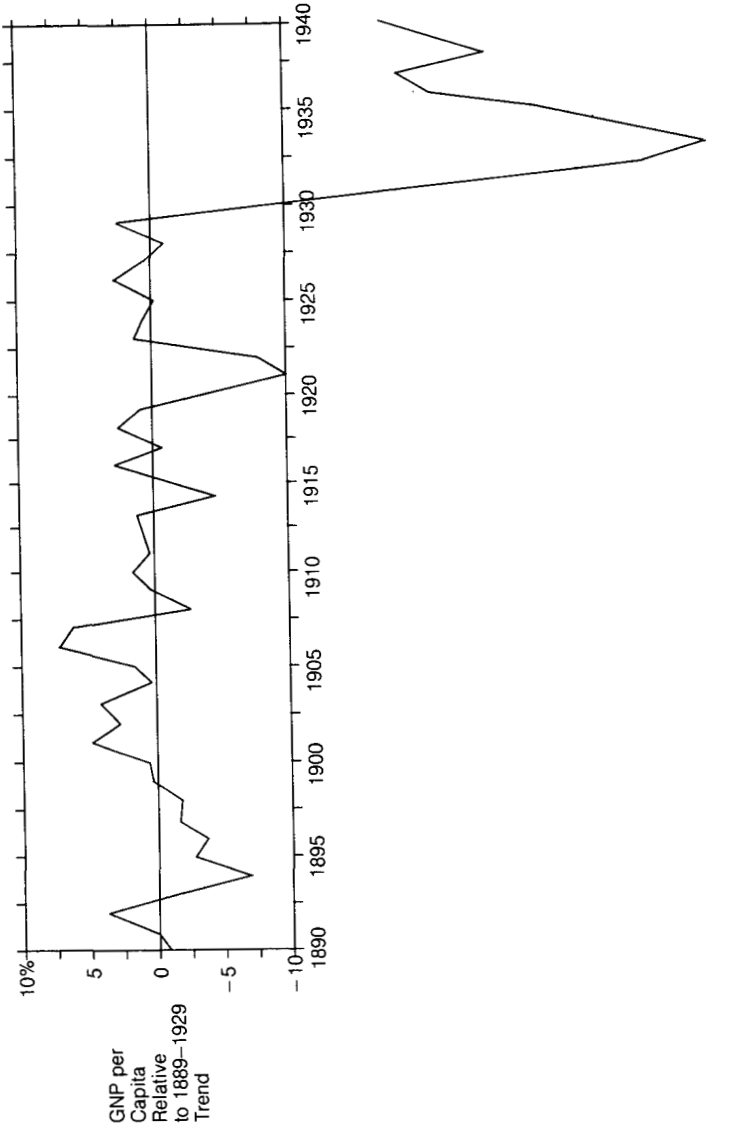

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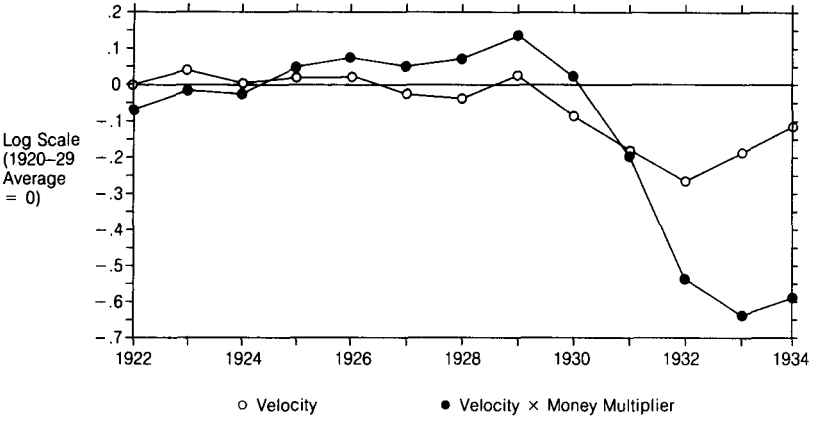
FIGURE 4

VELOCITY AND VELOCITY × MONEY MULTIPLIER IN THE DEPRESSION



regime of deflation had ended. We accepted Arthur Lewis's judgment that in the summer of 1933 "the [NRA] codes seemed to be making some contribution to recovery. . . . Their psychological effect was good; businessmen took heart from the prospect of rising prices, and began to give orders for goods. Unemployment fell a little" (Lewis 1949, p. 107). Lewis then went on to argue that once its initial effect on expectations had passed, the NRA's effects were largely negative.

Sumner points out that the NIRA was not the sole element of the first stage of the New Deal. Alongside Roosevelt's introduction of the NIRA came the abandonment of the gold standard and the adoption of a deliberate policy of forcing up the dollar price of gold—of devaluation. Sumner argues that such an abandonment of the gold standard was as clear a signal of the abandonment of the old deflationary regime as could be given, and that even in the absence of the NIRA the abandonment of the gold standard would have generated the same positive expectational effects. Peter Temin (1989) makes a similar argument that the key regime shift was the abandonment of the gold standard.

If we were rewriting our *American Economic Review* paper today, we would place less stress on the NIRA itself and more stress on the idea of the New Deal—encompassing both the NIRA and the abandonment of the gold standard—as the key to the shift away from deflationary expectations necessary to generate the beginnings of recovery. We thus think that Sumner's criticisms of our analysis of the NIRA have some force. But we remain somewhat skeptical that

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abandonment of the gold standard all by itself would have been sufficient to generate all the positive expectational effects of the entire New Deal package. Temin (1989) argues that Great Britain's abandonment of the gold standard was not fully efficacious because it was seen as an isolated action taken out of weakness, rather than as the beginnings of a nondeflationary regime of economic policy.

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On the Origins of the Sherman Antitrust Act

Robert L. Bradley, Jr.

A "Cynical" Interpretation of the Sherman Act

This year is the 100th anniversary of one of the most famous (or infamous depending on perspective) statutes in U.S. history: the Sherman Antitrust Act of 1890. This law banned business arrangements in restraint of trade (Section 1) and prohibited attempts to monopolize (Section 2). While much emphasis in this centennial year will be placed on the law's application, the origin and intent of the Sherman Act are also important to understand why the law has been used to restrain competition and efficiency rather than promote it (Armentano 1982).

This inquiry was inspired by an anonymous reviewer of the antitrust chapter in my forthcoming history of oil and gas regulation. He criticized my "cynical explanation of the passage of the Sherman Act, a view not shared by most contemporary economists." Indeed, while not neglecting the fact that there was public support for regulating the trusts and a congressional bias toward protecting small firms, I identified Congress's high tariff policy as an important reason for political support for the Act. I also mentioned that Senator John Sherman (R-Ohio) had a personal score to settle with a trust entrepreneur.

The antitrust specialist suggested that I turn to the commonly accepted explanations of William Letwin (1956, 1965) and Hans Thorelli (1955). Their correct interpretation, he stated, was that "the passage of the Sherman Act was motivated by widespread hostility

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The author is President of the Institute for Energy Research. This paper is adapted from Chapter 26 of his forthcoming book, *Oil, Gas, and Government: The U.S. Experience.*

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toward monopoly—considered to be detrimental to the interests of consumers and small business and also antithetical to democratic institutions."

After studying these standard accounts, I stand by my "cynical" interpretation of the Sherman Antitrust Act. I should add that the practice of antitrust enforcement, from the 1911 Standard Oil case and other early decisions to the present, has not rescued the law from its questionable beginnings.

The Textbook Interpretation

Many scholars have searched the record to better understand the origins and intent of the Sherman Antitrust Act. This interest has been inspired not only for the usual academic reasons but because the Sherman Act was very broad and ambiguous. They have properly concluded that Senator Sherman was the driving force behind the law, while Congress was relatively apathetic but supportive (Thorelli 1955, pp. 151–52, 162, 213, 215–16, and 218–20). Public opinion is found to be on the side of antitrust law (Letwin 1965, pp. 54–56, 58, and 70). Indeed, over a dozen states had already passed antitrust statutes similar to the bills under consideration by Congress. State-led activism, in turn, mirrored the "unscrupulous and often extra-legal" practices of the Standard Oil Trust (Thorelli 1955, p. 92) and industrial abuses of the agricultural sector (Letwin 1965, pp. 67–68).

Congress's high tariff policies are recognized as important in the trust debate. Sherman was an integral part of this policy. "As a true Republican," Thorelli (1955, p. 167) states, "he was unquestionably a pro-tariff man."

Thorelli (1955, p. 218) additionally posits that behind Congress's "indifference" was "ignorance," resulting from a lack of dedicated analysis of the voluminous data supplied by state and federal officials. He forthrightly devotes a special section to "The Problem of Congressional Interest and Sincerity" (Thorelli 1955, pp. 214–21).

All considered, these prominent writers conclude that since Sherman was sincere (if Congress was less so), the law had public support, and government regulation was merited in light of the trust problem. The law had sound intent to support its intellectual justification and real-world application.

Questions with the Conventional Wisdom

This textbook interpretation, however, raises three questions.

First, how great was the "public outcry" for trust regulation if Congress was ambivalent to Sherman's initiative? A different inter-

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pretation is that most Americans were benefiting from expanding production and lower prices in the "Trust Age" and were not as inflamed as some of the journalists and politicians around them. Petroleum (chiefly kerosene) output was expanding, prices were falling, and product quality and standardization were improving as Standard's market share rose (Bradley, forthcoming). "Agrarian distress" as a lightening rod for antitrust law is useless. Agriculture was not uniquely vulnerable to industrial monoply, and evidence suggests that railroad practices stabilized and expanded farmer income (Stigler 1985, pp. 1–11). Tariffs as a promoter of trusts did not sit well with many voters, which was differentiable from regulating trusts.[1]

Second, if Congress did not research the economic performance of trusts, how can it be assumed they did the right thing? In fact, a more recent interpretation suggests that Congress did enough analysis to understand that bigness could have economic benefits that antitrust law was not intended to disturb.[2] Economists at the time generally recognized scale economies favoring combinations and big business, and viewed competition as a dynamic process rather than a specific industrial structure (i.e., a certain number of separately competing firms).[3]

Third, how could Congress support high tariffs on the one hand and antitrust law on the other? Tariffs blocked foreign competition and facilitated combinations, output restrictions, and higher domestic prices. If big was not necessarily bad and tariffs were anticompetitive, the solution was to expand free trade to trust articles rather than to regulate "big business."

Sherman's Intent

Sherman's sincerity may have been no better than the "billion dollar" Congress as a whole. As the most influential member of the Senate Committee on Finance, Sherman was intimately involved in the nation's high tariff policies that protected virtually every major

[1]Carl Schurz, described by Thorelli (1955, p. 218) as "a keen observer" of the debate, described antitrust law as "a lightning rod to prevent the popular feeling against the trusts from striking the tariff."

[2]Robert Bork (1966, p. 12) stated: "Congress was very concerned that the law should not interfere with business efficiency. This concern, which was repeatedly stressed, was so strong that it led Congress to agree that monopoly itself was lawful if it was gained and maintained only by superior efficiency."

[3]See Gordon (1963, pp. 156–67) and DiLorenzo (1985, pp. 73–90). These findings contradict Letwin's (1965, pp. 71–77) finding that the economics profession was very mixed on the performance of combinations and trusts.

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U.S. industry (Thorelli 1955, p. 168). Reconciling this bias with his intense opposition to trusts is difficult. Thorelli cites Sherman's own rationale that properly structured tariffs promoted competition, while ill-conceived ones encouraged abuses. Thorelli (1955, p. 219) adds: "No one has successfully questioned Sherman's sincerity on this point." Yet did Sherman offer any theoretical or empirical evidence to substantiate what a "proper" tariff structure was? Was the McKinley Tariff Act of 1890, directed by Sherman just three months after his antitrust bill became law, composed of proper tariffs? Thorelli is conspicuously silent on these crucial points. Undoubtedly, Sherman had little concrete to say; the contradiction between competition and protection precludes a complementary relationship.

There are four other circumstances that suggest that there was more to Sherman's intent than his public antitrust pronouncements. (1) Why did he wait until July 1888 to begin his antitrust crusade? Trust regulation had political life since the 1870s, and some of the country's greatest trusts such as Standard Oil (1882) predated Sherman's attention by years. If it was so important an issue, why did Sherman not emphasize it during his campaign for the Republican nomination the year before? (2) Once it became a big issue to him, why did he not consider or even mention the "tariff [reduction] approach to domestic competition?" (Bork 1966, p. 16). (3) As Thorelli (1955, p. 170) notes, Sherman's version of an antitrust bill was "amateurish" compared to other bills submitted by his colleagues such as Senator John Reagan (D-Tx.). Sherman's version was a broad "catch all" despite his admission that some combinations were "lawful . . . in aid of production" in distinction to "unlawful combinations to prevent competition and in restraint of trade" (Thorelli 1955, p. 182). (4) Sherman was a tired politician in his mid-60s when he began his quest for a federal antitrust statute. William Letwin (1965, p. 87) described Sherman as "now an aging man at times impatient and confused" who "soon after [the Republican nomination] defeat . . . began to take serious interest in the trust question." What sparked the timing of this new interest? And how could a tariff man at the same time be an antitrust man? Another motivation was apparently present.

Solving the Puzzle

The missing piece of the puzzle concerns the man who blocked Sherman's front-running nomination for the Republican presidential nomination—Russel Alger. As head of the Diamond Match Company, Alger's trust became a target for a broadly based federal anti-

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trust law.[4] The deep antagonism was confirmed by President Benjamin Harrison, who with Alger's help defeated Sherman on the seventh ballot for the Republican nomination. Upon signing the Sherman Act into law, Harrison stated: "John Sherman has fixed General Alger" (Gresham 1919, pp. 574, 632).[5]

Thorelli (1955, p. 168) mentions and dismisses this revelation in a footnote by saying: "The present writer is unable to believe that such a personal matter would play a part of significance as a factor motivating Sherman with regard to the antitrust bill or, in fact, any other major legislative measure." Also in a footnote, Letwin (1965, p. 92) mentions the Alger-Sherman connection only to abruptly conclude that "revenge cannot have been Sherman's chief motive in pressing for the Act." Instead, Letwin (1965, p. 87) explains the timing with the presumption that "his recent disappointment [of the lost presidential nomination] gave him the urge to do something memorable." Elsewhere, however, Letwin (1956, p. 253) more seriously considered the Sherman-Alger connection. During the "great debate" preceding the passage of the antitrust act,

> [Sherman] first read the full opinion of the Michigan Supreme Court in the case of *Richardson v. Buhl*, which had a double attraction for him. It struck at the Diamond Match Company's monopoly, and it labeled as a monopolist General Russel Alger, one of his chief rivals in 1888 for the Republican presidential nomination, the one whom Sherman blamed for his unexpected defeat and publicly accused of having bribed delegates.

These authors' downplay of this striking connection of events can only be explained by their fundamental faith in the beneficence of antitrust law itself and an naive view of politics, especially given the notorious pro-business-subsidy 51st Congress.

Conclusion

The Sherman Act was bad law. It not only preserved the nation's high tariff policies by diverting attention away from the root restraint of trade; it greased the wheels for another tariff law later the same year. The McKinley Tariff Act of 1890, also called the "Campaign Contributors' Tariff Bill," shocked the *New York Times* into revers-

[4]Interestingly, and perhaps coincidentally, the match industry was only one of two of 17 major industries that showed reduced output between 1880 and 1890 (DiLorenzo 1985, p. 19).

[5]Sherman remained bitter about the incident for many years (Letwin 1965, p. 92).

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ing its once ardent support for the Sherman Act.[6] With tariffs and antitrust, the government at best was trying to undo with one hand what it was doing with the other. But at worst, as applications of the law would demonstrate, the Sherman Act discouraged scale economies that promoted lower costs and prices, penalized successful market entrepreneurship, and rewarded the political entrepreneurship of less-efficient business rivals.

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[6]On October 1, 1890, the *Times* stated: "That so-called Anti-Trust law was passed to deceive the people and to clear the way for the enactment of this . . . law relating to the tariff. . . . And now [Sherman] can only 'hope' that the rings will dissolve of their own accord" (p. 2). Quoted in DiLorenzo (1985, p. 83).

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James M. Buchanan
College Station: Texas A&M University Press, 1989, 437 pp.

This book collects 31 of Nobel Laureate James Buchanan's papers on a wide range of topics, but all are related by their constitutional approach to economics. The selections were compiled by Robert Tollison and Viktor Vanberg, who have chosen papers that are less well known than the contents of some earlier collections of Buchanan's work. The volume serves two purposes: It makes some of Buchanan's less-familiar work more accessible, and it illustrates both the theory and application of constitutional economics. The common theme gives the papers in this volume more impact when they are considered together than if each were read individually.

Throughout his career, Buchanan has emphasized that institutional constraints are important determinants of the actual workings of economic systems, and constitutional economics studies are the properties of alternative sets of institutional rules. The first five chapters of this volume discuss the theoretical foundations of constitutional economics. Chapter 1, coauthored with Geoffrey Brennan, deals with the application of economic models to public policy questions, and it is a good choice to begin the volume. Brennan and Buchanan discuss the assumption that individual behavior is self-interested, a point that is readily accepted in models of market processes but which is more controversial in models of political processes. It is often argued that this model of economic man is not descriptive of the actual behavior of individuals in the public sector, but Brennan and Buchanan conclude that regardless of its descriptive accuracy, the assumption that public servants are self-interested is the appropriate standard to use when evaluating the probable performance of alternative institutions. Institutions work better when they are designed to guard against the possibility that some people might try to use them for selfish reasons.

In Chapter 2, Buchanan discusses the impact of public choice theory on public policy issues. By applying the same type of analysis economists

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have used in evaluating market institutions to the study of political institutions, public choice has, at the very least, forced discussions of public policy options to recognize the potential shortcomings of political solutions. As in Chapter 1, Buchanan notes that public choice models are not always fully descriptive of human behavior, but again he emphasizes the relevance of this approach in designing institutions that are not overly dependent on public-spirited behavior in achieving success.

Chapter 3 deals with rational choice models frequently used in the social sciences. Extending the themes of the first two chapters, Buchanan argues that use of these models ultimately allows the development of better institutions. Chapter 4 considers the relationship between citizens and their governments, focusing on the coercive nature of government, and Chapter 5, titled "Constitutional Economics," explains Buchanan's views on the scope of constitutional economics.

The first five chapters provide a methodological foundation for analyzing institutional rules, and the remainder of the book applies this methodology to a variety of topics grouped into five major categories. Four chapters are devoted to voting, four discuss the monetary and fiscal constitution, five chapters examine public goods supply, seven address taxation and public debt, and six chapters cover property rights and externalities. Taken as a group, these chapters illustrate the application of Buchanan's constitutional approach to political economy.

Under the heading of voting, for example, Buchanan analyzes the familiar cyclical majority model from an institutional standpoint. Buchanan distinguishes between those cases where decisions are relatively permanent, such as where to locate a new facility, and those cases where decisions are more temporary, such as the election of a candidate to public office. In the second set of cases, the rotation of office holders that is produced with cyclical majorities would be desirable. This observation naturally leads into a discussion of the optimal length of the terms of elected officials. In another chapter in the voting section, Buchanan and Geoffrey Brennan conclude that voters make political choices using different criteria than those used in market decisions, and the authors explore the implications of those differences in individuals' decision-making processes.

In the monetary and fiscal constitution section, Buchanan discusses the benefits of constraining policymakers with well-defined constitutional rules rather than allowing them to use their discretion to determine policy. Rules versus discretion is an on-going debate among economists, and Buchanan applies the constitutional paradigm to support the rules side of the argument. Adherence to constitutional rules not only would insulate monetary policy from self-interested political behavior, but it also would provide a predictable monetary environment. And Buchanan emphasizes the importance of predictability. No matter how knowledgeable and public spirited monetary authorities are, the benefits of predictable policy can never be obtained as long as policymakers can implement whatever policy they think is best.

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In the section on public goods, Buchanan and Francesco Forte persuasively argue that including government production in GNP at cost is inconsistent with the theory of national income accounting. Government output should be added to GNP only when it is sold on the market, and then it should be included at the price it brings. Private sector output is included in GNP at its market value, and the market value of government output that is given away is zero. The importance of their argument extends beyond the conventions of national income accounting, because they are ultimately illustrating that at the margin, much government output is worthless.

The other chapters in the public goods section address traditional public goods theory. Buchanan and Milton Kafoglis challenge the standard conclusion that privately provided public goods will have too few resources devoted to their production. Buchanan and António S. Pinto Barbosa question the convexity assumptions that are made in formal models of public goods. The last two chapters in this section were originally published as comments on the work of others, and both offer an insightful analysis of optimality conditions in the production of public goods.

The seven chapters on taxation and public debt illustrate the constitutional approach by emphasizing the institutions of taxation and public finance. Buchanan and Richard Wagner respond to critics of their 1976 book, *Democracy in Deficit*, itself is a good example of the constitutional approach. Rather than analyze public finance from the standpoint of choosing the best policy in an abstract setting, Buchanan and Wagner look at the incentives created by the institutions of public finance. They illustrate that, unless those who determine government budgets are constrained by an implicit or explicit balanced budget rule, budget deficits are inevitable.

Several chapters raise interesting issues with regard to taxation. Brennan and Buchanan develop a model that would allow the tax base to be constitutionally determined, and they demonstrate that the selection of tax bases correlated with the production of specific public goods can make government more productive. This provides a constitutional argument for earmarked taxes. Other chapters deal with progressive taxation, selective versus general taxes, and coercion in tax systems. The emphasis is always on the public choice analysis of the selection of tax rules with the political process fully integrated into the model.

The final section in the book addresses property rights and externalities and in doing so analyzes the Coase theorem, compares private with communal ownership, and considers the effects of small versus large numbers in bargaining for resource allocation. As in the earlier chapters, the constitutional approach provides the foundation for analysis. The Coase theorem demonstrates that in a world with no transactions costs, resources will be allocated to their highest valued uses. It typically is applied to a market setting that fails to include government as a part of

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the institutional framework. Buchanan illustrates the insights that can be produced from Coase's theorem once the role of government is explicitly recognized. His application of the Coase theorem to majority rule voting shows how efficient outcomes can be produced in voting groups where side payments are possible. Buchanan's application of the theorem to the administrative branch of government establishes that it holds for members of the decisionmaking group, for whom the zero transaction cost assumption is approximated. An important determinant of public policy, then, is who is included in the policymaking group.

Each chapter of this volume, taken individually, yields insights into the rules that govern public sector decisionmaking. The volume taken as a whole illustrates the power of the constitutional approach both in understanding public sector institutions and in developing methods for improving them. In traditional public sector economics, suggestions for improvement tend to be primarily recommendations that existing policymakers do things differently. The constitutional approach, in contrast, recognizes that the behavior of policymakers is largely determined by the rules of the game. Thus the actions of policymakers and citizens should be constrained by the rules selected. Constitutional economics explains why an orderly society requires rules, and develops models to try to improve the constitutional rules under which societies operate.

Tollison and Vanberg have compiled a valuable set of Buchanan's papers that illustrate by example the benefits of the constitutional approach to political economy.

Randall G. Holcombe
Florida State University

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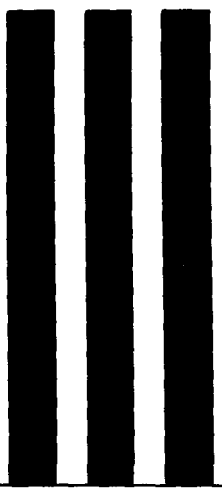

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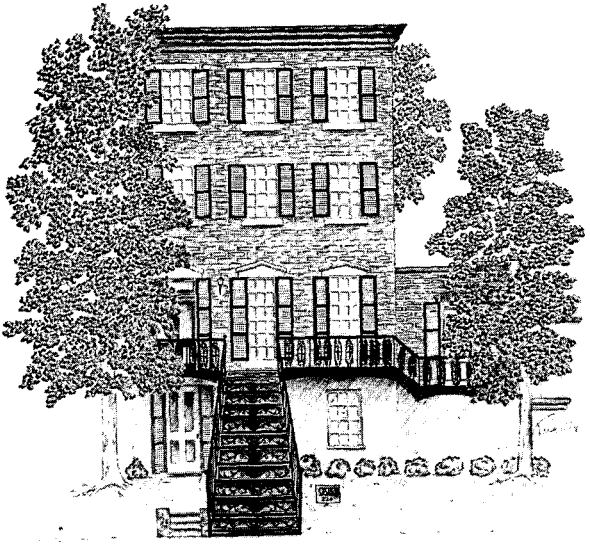

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PROPERTY RIGHTS AND THE MARKET

Markets without divisible and transferable property rights are a sheer illusion. There can be no competitive behavior, real or simulated, without dispersed power and responsibility. And it will not do to disperse the one without the other. If all property is to be literally collectivized and all pricing literally centralized, there is no scope left for a mechanism that can reproduce in any significant respect the functioning of competitive private enterprise.

—**G. Warren Nutter**

"Markets without Property: A Grand Illusion." In *Money, the Market, and the State.* Edited by Nicholas A. Beadles and L. Aubrey Drewry, Jr. Athens: University of Georgia Press, 1968, pp. 144–45.

The market is based on the freedom of people within the framework of valid laws, assuring equal rights for all. It gives every individual the opportunity to follow his own interests and at the same time to benefit all others. . . . A market is not a tool of the Government. Rather, the Government is responsible for creating the framework conditions for [its] functioning.

—**Marian Calfa**
Prime Minister of Czechoslovakia

Quoted in the **New York Times,**
20 December 1989.

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